Business Strategies and Free Trade

Focus on Corporate Adjustment

Policy Study No. 5
C.D. Howe Institute

edited by
Maureen Farrow
and
Alan M. Rugman

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C.D. Howe Institute

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Foreword

The signing of the preliminary Canada-U.S. Free Trade Agreement on October 3, 1987, led the C.D. Howe Institute and the Faculty of Management at the University of Toronto to consider presenting a forum at which Canadian business leaders could examine the Agreement's potentially significant changes to the economic environment in which they will operate. The outcome was the joint sponsorship of a conference on "Business Strategies and Free Trade", held in Toronto in January 1988. This publication presents the key papers prepared for the conference.

The focus of the two-day meeting was to shift attention from the pros and cons of the Agreement to a discussion of the fundamental question of how Canadian businesses should respond and adapt to it. Leading economists and business strategists facilitated the discussion by offering their technical expertise on how the Agreement is likely to change the business operating environment. The discussion was also enriched by the contributions of executives in a number of key exporting industries, who informed participants in practical terms how their organizations are responding to the new global competitive challenge. In addition, the Chairs of the 15 Sector Advisory Groups on International Trade (or their delegates) presented the views of their groups on the Agreement's implications.

Several themes were developed at the conference and run through the papers in these proceedings. One theme is that Canadian business must learn to adjust if it is to prosper in the international business environment of the 1990s. Past experience shows that Canadian business has the ability to adapt, and the free trade initiative should be recognized as one more step on the road to trade liberalization that started over 40 years ago.

Another theme is that the adjustment process should be viewed as a continuous exercise in the development of new products, the streamlining of facilities, the adoption of new technologies, and the development of new markets. At the conference, strategic planning specialists demonstrated that the tools are available to assist management in understanding the new environment and in making sound decisions. Business leaders clearly articulated their success to

date and their optimism about Canada's ability to compete. The conference participants recognized that, although the Canada-U.S. trade initiative is important, it is simply part of an ongoing change in the global trading environment.

Alan Rugman and I were responsible for organizing the conference, with the able assistance of Sonia Alleyne and Brenda Huff. The proceedings were prepared for publication by Barry Norris, Director of Publications, with assistance from Cordelia Sharpe.

The conclusions presented here are those of the authors, and do not necessarily represent the views of the Institute's members or directors.

Maureen Farrow
President

Introduction

In late January 1988, the C.D. Howe Institute and the Faculty of Management of the University of Toronto sponsored an important two-day conference in Toronto on "Business Strategies and Free Trade".

The conference took place after the Canada-U.S. Free Trade Agreement had been signed but before ratification by Parliament and the U.S. Congress. This was the first opportunity for influential members of the business and financial communities to meet together to assess the impact of the Agreement on their strategic planning. Helping to provide direction for this analysis was a team of experts in strategic management, government trade officials, and business leaders.

The conference speakers and chairs included members of the federal government's International Trade Advisory Committee (ITAC) and all 15 Chairs (or their delegates) of the Sector Advisory Groups on International Trade (SAGITs). These individuals had been involved as representatives of the private sector in the process of the free trade negotiations. Also featured were a cabinet minister, the deputy trade ambassador, the Chairman of the Economic Council of Canada, the President of the Canadian Manufacturers' Association, a number of chief executive officers, several consultants, senior economists from the C.D. Howe Institute, and strategic management professors from the University of Toronto.

The 200 delegates made a valuable contribution to the success of the conference by participating in small group discussion, asking questions, and interacting with conference speakers. The delegates included representatives from the services sector, manufacturing, resources, consulting, and government.

This proceedings issue contains the key papers prepared by the team of strategic management professors, consultants, and economists. Also included are the opening remarks by Judith Maxwell, Chairman of the Economic Council of Canada, and a report on the SAGIT sessions.

Adjusting to Free Trade: The Track Record

Judith Maxwell

Introduction

I would like to congratulate the C.D. Howe Institute and the University of Toronto Faculty of Management for organizing a conference that shifts our focus from whether or not we should enter a free trade arrangement with the United States toward the question of how industry can adapt. I hope I can help set a framework for the discussions at this conference by talking about the way Canadian industry has responded in the past. The Economic Council of Canada has done a considerable amount of work on adjustment issues in recent years, and we will be publishing a document in a few weeks' time called *Managing Adjustment: Policies for Trade-Sensitive Industries*.[1] The work that I will be reporting to you today provides part of the background to that study.

So far, the debate on the Canada-U.S. Free Trade Agreement has been based, to a considerable extent, on the mistaken impression that we are entering a totally new era, that the implementation of the accord would herald a completely new and unpredictable situation

[1]Economic Council of Canada, *Managing Adjustment: Policies for Trade-Sensitive Industries* (Ottawa: Supply and Services Canada, 1988).

for Canada — a first encounter with a threatening new environment.

In ancient times, cartographers drew maps showing the then unknown part of the world as they believed it to be. Beyond the familiar boundaries that European navigators knew, many misconceptions are visible. Fears of the unknown, too. One finds inscriptions such as "Beware! In this area be sea dragons". And then it turns out that they were talking about the Bay of Fundy.

The first point I want to make is that liberalized trade is not completely unknown territory for Canadians. Over the past 40 years, and particularly in the past 15 years, we have come a long way in trade liberalization — both globally and in our relationship with the United States.

After the Second World War, Canada's average nominal tariff on dutiable U.S. goods was about 22 percent,[2] and more than one-half of all U.S. goods coming into Canada were dutiable.[3] By 1987, after the Tokyo Round, the nominal tariff rate on U.S. dutiable imports was under 12 percent,[4] and less than one-third[5] of U.S. goods imported into Canada were subject to duty.

The point is that when we try to predict the impact of further liberalization, we do not need to base all our projections on theory. There is a body of experience to go on — a well-documented history spanning four decades to consult. It is possible to make before-and-after comparisons of how the economy performed as liberalization advanced. We can find clues to the future behavior of companies — Canadian and others — by looking at the way firms responded to falling trade barriers in the past. I admit that, in consulting the historical record, we must also take into account some of the changes that came after trade liberalization. One of the most significant of these is the increased globalization of markets — the emergence of

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[2]Department of Finance, *The Canada-U.S. Free Trade Agreement: An Economic Assessment* (Ottawa, 1988), Chart 5.

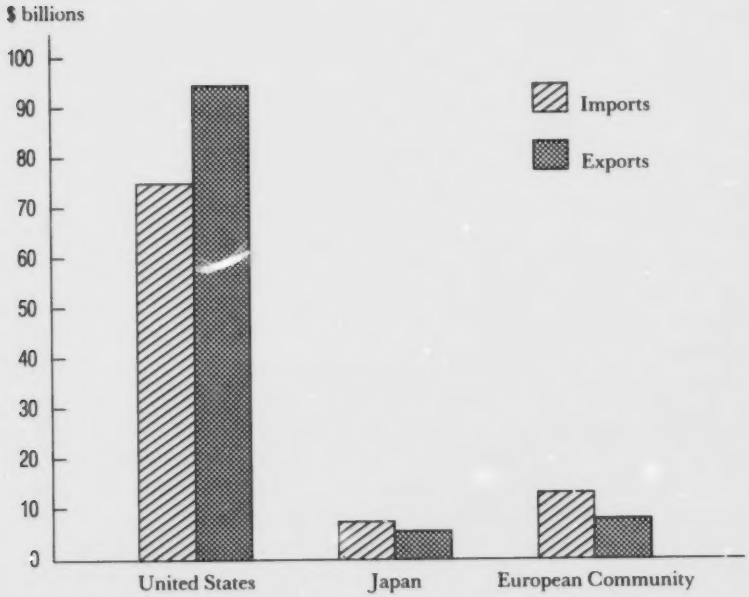
[3]H. Pinchin, *The Regional Impact of the Canadian Tariff* (Ottawa: Economic Council of Canada, 1979).

[4]Department of Finance.

[5]Estimate of the Economic Council of Canada, as reported in S. Magun et al., *Open Borders* (Ottawa: Economic Council of Canada, forthcoming).

Figure 1

Canada's Trade with the "Triad Economy", 1986



Source: *Bank of Canada Review*, July 1987.

what some people call the "Triad economy". This is the combined market of the United States, Japan, and Europe — about 630 million customers.

These are new factors and important ones. But, here again, they have not been entirely outside the circle of Canadian experience. The Triad itself is not *terra incognito* for Canadians.

Figure 1 shows the extent of Canada's trade with these countries. In 1986, we sold $94 billion in goods to the United States, $6 billion to Japan, and $8 billion to the European Community. In 1987, our sales to Japan and Europe were rising rapidly, thanks to the currency realignment that has taken place since 1985.

Canada is also linked to the Triad market through the activities of

multinational firms. Approximately 70 percent of all Canadian imports are accounted for by foreign-owned firms, mostly U.S. In the case of Canadian-U.S. trade accounted for by multinationals, the vast majority is intra-corporate in nature. So, a large share of Canada's trade is being conducted by people with a solid understanding of the two markets.

Another relatively new development is the proliferation of "global products". Today, the world carries Walkmans, runs on Adidas shoes, and takes to the air in Boeing jets.

Canadians who see global products as completely foreign artifacts may be pessimistic about our ability to get in on *this* part of the action. But, even here, the truth is that we are not bystanders or even newcomers. A whole network of alliances and partnerships has developed to serve continental and global markets — we are among the allies and partners.

Canadian companies produce not only for local markets but for continental and global ones as well, although in some cases this may not be obvious from outside the factory gate. The General Electric Canada plant in Bromont, Quebec, manufactures blades and vanes for aircraft engines made by General Electric in the United States. So whenever you are traveling in a jumbo jet, you are, at least in part, flying Canadian. And for sales of its products, GE is competing with Pratt & Whitney and Rolls-Royce in a global market. So we are part of the Triad economy; we are involved in global products.

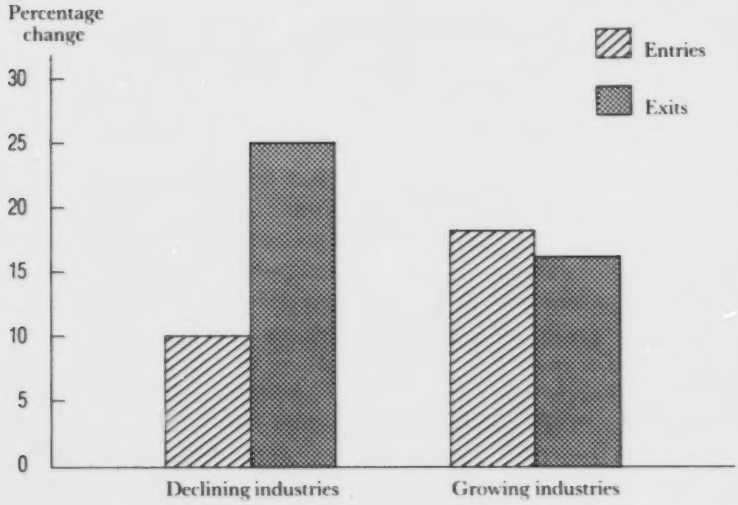
That raises another question. How, and to what extent, would the Canada-U.S. Free Trade Agreement help us to do better? Again, there are hints in the record.

Adjusting to Falling Trade Barriers

As it happens, the Economic Council of Canada has done a lot of serious analytical work on the way Canadian industry in general, and the manufacturing sector in particular, adjusts to falling trade barriers. Much of this work has been published in a series of discussion papers co-authored by John Baldwin, of Queen's University, and

Figure 2

Impact of Firm Entry and Exit Rates on Employment in Declining and Growing Industries in Canada, 1970–79



Source: Statistics Canada, Special Tabulations, Business Microdata Integration and Analysis.

Paul Gorecki, a Senior Economist at the Council.[6]

One important fact emerges: what determines the growth or decline of an industry is not just the rate of failure of firms, but the rate at which new firms are created.

Figure 2, which is derived from the work of Baldwin and Gorecki,

[6]See J.R. Baldwin and P.K. Gorecki, with J. McVey and J. Crysdale, *Entry and Exit to the Canadian Manufacturing Sector: 1970–1979*, Discussion Paper no. 225 (Ottawa: Economic Council of Canada, 1983); idem, *Trade, Tariffs, Product Diversity and Length of Production Run in Canadian Manufacturing Industries: 1970–1979*, Discussion Paper no. 247 (Ottawa: Economic Council of Canada, 1983); and idem, *Trade, Tariffs, Relative Plant Scale in Canadian Manufacturing Industries: 1970–1979*, Discussion Paper no. 232 (Ottawa: Economic Council of Canada, 1983).

covers 141 Canadian manufacturing industries from 1970 to 1979. Dividing these industries into those that were growing and those that were declining, and looking at the impact on employment, we see that exits from growing industries caused a 16 percent decline in employment over the ten-year period. Exits from declining industries caused a 25 percent drop in employment. Thus, jobs are lost in both categories. What determines the growth in employment is the rate of entry. Entry of new firms increased employment by 18 percent over ten years in the growth industries, and by only 10 percent in the declining industries.

This work suggests very strongly that an important factor that differentiates an expanding industry from a declining one is the rate of entry of new firms. These findings are consistent with work done elsewhere, for instance by David Birch, showing that more than 50 percent of new jobs in Canada are created by small firms — a large share of which we can assume are *new* firms.[7]

Meanwhile, firms have been responding to falling trade barriers by streamlining, specializing, and adopting new technologies. Table 1, which is based on data developed by Statistics Canada, indicates that some have responded by shrinking, while others have grown. The net job change in commercial industries was 849,000 from 1978 to 1985. There is nothing startling about that number. But what is very impressive is the gross turnover in jobs.

Gross employment increased by 3.2 million, composed of 1.5 million new jobs in expanding firms and 1.7 million jobs in new firms. These gains were partly offset by job losses of 2.3 million by firms contracting or going out of business. This is a description of a dynamic manufacturing sector. Note that large firms, and especially foreign-owned firms, showed a net decline in employment. But again, the net change masks large increases by some firms and decreases by others. This is the way structural change in the economy occurs over time.

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[7]Department of Regional Industrial Expansion, *A Study of Job Creation in Canada, 1974–1982* (Ottawa, 1985). A small firm is defined as one having fewer than 20 employees.

Table 1

Employment Changes in Commercial Industries, by Life Status of Firms, 1978–85

(thousands of jobs)

Numbers of jobs	All firms	Large firms[a]	Large foreign-owned firms
Continuing firms			
Growing firms	1,520	687	191
Declining firms	-1,025	-615	-199
Total continuing firms	*495*	*72*	*-9*
New and exiting firms			
New firms	1,663	262	51
Exiting firms	-1,308	-379	-93
Total, new and exiting firms	*355*	*-117*	*-42*
Total	*849*	*-45*	*-51*

[a]Large firms are defined as those having more than 100 employees.

Note: Totals may not add up due to rounding.

Source: J.S. McVey, "Notes on Employment Change of Domestic and Foreign-Controlled Firms, 1978–85" (Ottawa, Business Microdata Integration and Analysis, Statistics Canada, November, 1987), Tables 1, 4.

Another sign of the dynamism of the manufacturing sector is the revitalization that takes place through investment. Baldwin and Gorecki have shown that, over a ten-year period, about 40 percent of firms leave a typical manufacturing industry, mostly through plant closures.[8] These exiting firms are quickly replaced, however, by start-ups of new firms, creating a considerable number of jobs. The remaining 60 percent of firms adjust in ways that generally require either modernization or expansion. What these two strategies have in common is that they cost money up front. Indeed, one of the immediate reactions to a trade agreement will be a surge in business investment as continuing firms begin to adjust. These adjustments fall into four categories.

[8]Baldwin and Gorecki, *Entry and Exit to the Canadian Manufacturing Sector*, Table 4.

First, firms often respond to the disappearance of trade barriers by specializing. Behind a tariff wall, it may well make sense to produce an assortment of products in short runs. When the wall goes down, however, there is an incentive to concentrate on a limited number of products. This probably explains why there has been such rapid growth of intra-firm, intra-industry trade over the past 15 years. Specialization is good for competitiveness. Making the change requires investment.

A second response is to move up the value-added chain. This occurs because tariffs tend to be higher for higher-value-added goods, creating a bias against further processing. Adding value usually requires additional investment and the use of new technologies.

Third, freer trade encourages firms to expand their capacity. They do so both to meet increased demand from existing markets and to penetrate new markets. In either case, expansion requires investment.

Finally, there are the investments required when companies move into new geographical markets. Some Canadian businesses will certainly plan to locate some new plants in the United States, in order to take advantage of the particular cost or marketing advantages that country offers. U.S. firms will do the same in Canada.

The Role of Multinationals

That brings us to a worry that has nagged some observers, and that is particularly pertinent in Ontario. Some plants that now exist in Canada were built here by foreign companies and multinationals expressly to get around Canadian tariffs. With the tariffs gone, will the multinationals fold their tents and fade away?

Here again, we can learn something from the record. What happened in the 1970s and early 1980s, when barriers fell?

A considerable amount of research has been focused on this particular question — some of it done for the Council. These studies show that the so-called tariff factories did not shut down. Having "sunk costs" in these plants, multinationals are not inclined to scrap them. In the Council study *Managing Adjustment*, Don McFetridge of Carleton University presents a statistical analysis of the way U.S.

multinationals have responded to falling trade barriers in all parts of their global network, including Canada.[9] Let me summarize some of his main conclusions:

- U.S. multinationals are less inclined than other companies to pack up and leave for cheaper sources at the slightest provocation. They are evidently more able to distinguish between short-term and long-term opportunities and between pressures that are temporary and those that are structural. Typically, they are long-term thinkers and planners. They ride out the short storms — for example, swings in exchange rates — and, for this reason, are stabilizing forces in the employment situation of their host countries. On the other hand, where genuinely long-term changes in the equation are concerned, they are more likely to respond than are domestic firms.
- In particular, when domestic demand falters, the average multinational firm is *no* more likely to close down the plant than is a home town firm.
- Evidence about the readiness to respond to trade liberalization by rationalizing is mixed. U.S. multinational firms and Canadian firms appear, however, to respond in much the same way.
- There are also some interesting findings on the relative growth of the operations of U.S.-owned companies in Canada compared with their operations in all the other industrial countries. In some of the 30-odd industries McFetridge looked at, Canada's share of employment in the operations of U.S. firms in the industrial countries has increased; in other industries, it has fallen. What is important is that Canada's share has increased in industries where world trade is expanding and where R&D activity is important. In other words, we have been most successful in gaining a share of employment of U.S.-owned multinationals in "sunrise" industries.
- Another surprise for many: Canada's share of North American employment of U.S. multinationals has increased in industries where trade barriers have been falling. Where its share of employment in

[9]D. McFetridge, "Trade Liberalization and the Multinationals," in Economic Council of Canada, *Managing Adjustment*.

total multinational operations has declined the most has been in industries where trade barriers have declined the least.

The bottom line is that Canadian and foreign-owned firms tend to adjust in much the same way. Where there are differences, the presence of foreign-owned firms seems to enhance, rather than to diminish, the ability of Canadian manufacturers to adjust to change.

In his study, McFetridge focuses on the past — and on the subject of what happens to existing plants. But what about new plants? In the free trade era, will multinationals continue to establish new plants in Canada? For that matter, will Canadian firms do so? Or will everyone be tempted to locate in the United States?

The answer depends on the "locational advantages" the company sees in Canada. What it sees hinges, to a degree, on the nature of the business, the type of product, and other characteristics. But some competitive advantages are relevant to all — and to that extent, it is safe to generalize. A spokesman for Digital Equipment Corporation recently had this to say about location criteria:

> Competitive advantages go far beyond just cost. We need to look at markets, the quality of the labour force, service, networking, delivery. All those things contribute to a competitive advantage, whereas companies that just chase after the cheapest production are always chasing it.[10]

What evidence do we have that Canada offers these generic advantages? Here again, a useful guide is the history of what happened in the trade-liberalizing 1970s and early 1980s.

Let us look, for instance, at the auto pact. As we know, the pact contains certain safeguards. One is that for every car sold here, U.S. manufacturers must assemble one here; another is that Canadian content in the car must be 60 percent. Two decades into the pact, we find Canadian content — Canadian components — running not at

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[10] "Superior Products May Be U.S. Trade Deficit Solution," *Los Angeles Times*, September 22, 1986, p. 1.

60 percent but at 80 percent. And the assembly-to-sales ratio is well over 100 percent.[11]

Let's think about that. The Big Three are buying more here and producing more here than the pact requires them to. And they are doing so for solid business reasons: Canada has a competitive advantage.

Let me suggest some of the advantages that a chief executive officer in the United States may see when he or she looks at Canada:

- A favorable exchange rate relative to the United States and one that is likely to stay that way for the foreseeable future.
- A modern, unrusted, steel industry — an important advantage not only to the automotive industry but to other industries as well.
- Labor costs that, when all parts of the package are figured in, are lower than those in the United States.
- An educated work force with a genuine capacity for teamwork and a demonstrated ability to put together the innovative forms of human organization that are so relevant in the use of new technology. In *Making Technology Work*,[12] the Council spells out how vital organizational change is to competitiveness, and Canadian business leaders with experience in the United States say that Canadian workers are more naturally team players than are U.S. workers. They believe we have a distinct advantage here, although the Council's research shows that not many Canadian firms are exploiting this advantage. So, we have a lot to gain here.
- Another factor — intangible, but nevertheless real — is the advantage of *not* being a superpower. This has allowed Canadians to avoid many of the confrontations and controversies that so easily impede business transactions. Canada is an acceptable host for virtually all investors — and an attractive partner in most global enterprises. This

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[11]Trade Policy Team, "A Sectoral Analysis of the Canada-U.S. Free Trade Agreement" (Economic Council of Canada, Ottawa, January 1988, Mimeographed), Tables 12 and 13.

[12]Economic Council of Canada, *Making Technology Work: Innovation and Jobs in Canada* (Ottawa: Supply and Services Canada, 1987).

explains why so many European companies are coming here looking for partners.

In some investment horse races, these factors can be winning edges.

Conclusion

How, then, will Canadian industry respond to the Free Trade Agreement if it is implemented? What will be the effect on investment in this country?

We can expect to see the emergence of new global alliances involving Canadian firms. We will also see the employment of every conceivable type of corporate strategy by Canadian, U.S., and offshore firms to reach the total North American market. Some firms will invest here, and some will invest in the United States.

Where the investment will come from, and what the balance will be, is hard to say at this stage. The important message from the Council's work on adjustment is that a great deal of this investment will come from new firms that are not now in existence. But the record of past behavior is clear. Firms can and will adapt. New firms will start up new businesses.

In the debate on the Agreement — to the extent that we can call the present rhetoric a debate — the largeness of the United States relative to Canada is often treated as a negative factor. The implication is that the Agreement would be a better deal for Canada if only the weight of the U.S. political process were smaller. But the flip side of that factor is the potential economic opportunity for Canadian firms in gaining access to a market ten times our own size.

To sum up, whatever emotions freer trade should reasonably incite in Canadians, fear of the unknown should not be one. This environment of freer trade is not *terra incognito*. We have been in the territory for quite some time and we have fared pretty well. There are many examples of peoples and their governments who have not learned from history. In this instance we should.

Strategic Responses to Free Trade

Alan M. Rugman ***Alain Verbeke***

The Free Trade Agreement and Corporate Adjustment

The objective of this paper is to develop a new conceptual framework to analyze the strategic options available to Canadian corporations operating in a new trading environment. The framework is particularly useful for large multinational enterprises, both Canadian-owned and foreign-owned, with markets in Canada and the United States. Within this framework, we predict their potential strategic responses to the Canada-U.S. Free Trade Agreement. We pay particular attention to issues of corporate adjustment and the social impact, if any, of such adjustment.

Once the Canada-U.S. Free Trade Agreement was signed on January 2, 1988, it became imperative for Canadian corporations to rethink their strategic planning for the 1990s. The Agreement still faces some potential legislative obstacles before it becomes effective on January 1, 1989. It is apparent, however, that this major trade

deal significantly changes the environment for international business.

To strategic planners in large corporations, the adjustment issue is a familiar one; the whole point of strategic management is to assess external environmental changes and to design internal strategies and structures to accommodate such changes. The greater the degree to which external shocks can be predicted the lower is the risk to the firm, since appropriate policies can be implemented to minimize the costs of adjustment.

Corporations will find it easier to adjust to the new business environment, since the private sector was consulted about many of the details in the agreement. More than 300 chief executive officers and presidents, for example, participated in 15 Sector Advisory Groups on International Trade (SAGITs). These SAGITs met regularly with trade officials and ministers over the past two years to help formulate the Canadian position in the trade negotiations. In this interactive process, many of the potential adjustment problems of Canadian corporations were discussed and often steps were taken to minimize the adjustment process.

For example, government can help corporations that face real adjustment costs in two major ways. First, firms can receive direct financial assistance in the form of low-interest loans and other subsidies to help restructuring and plant relocations. Second, they can benefit from long phase-ins before new trade regulations become effective. In general, the Canadian government has worked with the private sector to ensure that the second method of adjustment assistance is in place. One illustration of this is that the Agreement cuts all bilateral tariffs to zero by the end of a ten-year period. Yet, many industries volunteered to face quicker tariff reductions; the final text of the Agreement reflects numerous examples of such phased tariff reductions.

These two points — the ongoing nature of strategic planning as corporations adjust to changes in environmental conditions, and the active participation of the private sector in the trade negotiations — lead to an important conclusion. Corporate adjustment to free trade is already under way, and the Agreement will have an adverse effect on few of Canada's large corporations. Indeed, most of them are

hungry for free trade. Now that we have it, we can watch Canada's corporate leaders take the opportunity to organize for future prosperity.

Free Trade and Large Multinationals

This focus on the strategic planning of large corporations is justified, of course, since the great majority of economic activity in Canada is carried out by such firms. Indeed, as much as 70 percent of Canadian-U.S. trade is carried out by multinational enterprises, the majority of this by about 40 companies with sales of a billion dollars or more. These members of the "billion dollar club" consist of a set of Canadian-owned multinationals such as Northern Telecom, Alcan, Noranda, and so on, plus a set of foreign-owned subsidiaries such as General Motors of Canada, Ford Motor Company of Canada, General Electric Canada, Du Pont Canada, and so on. These firms are already well positioned in terms of global competitive strategy, and the impact of the Free Trade Agreement on them will be neutral at worst but otherwise favorable.

These large multinationals are already integrated across the Canadian-U.S. border. Often, they made initial plant location decisions based on the need for secure access to markets in the two countries in the face of barriers to exporting. Now, however, virtually all of them continue to produce and distribute through foreign subsidiaries for other managerial motives, such as the need to service customers, to be close to suppliers, to accommodate local political interests, and so on. Stated more formally, most of these multinationals have erected entry barriers that they naturally wish to maintain against potential rivals.

The major impact of the Agreement on the billion dollar club is simply to improve the investment climate. The Agreement achieves this by codifying the rules of the game. In the past, firms were subject to arbitrary changes through the process of decentralized administered protection, as occurred, for example, in the use of U.S. trade remedy law cases. Dispute settlement through the new binational appeal body should lead to more objective analysis by the trade agencies, the negation of frivolous cases, quicker decisions, and an

overall improvement in the trade climate. The elimination of such uncertainty is the essence of good strategic planning, so the larger multinationals will benefit from this and related aspects of the Agreement that improve market access.

Free Trade and Small and Medium-Sized Companies

Two other types of Canadian corporations need to be considered. First, there are the small and medium-sized businesses that produce in Canada and export to the United States. Clearly, these firms will benefit from secure and relatively open access to the U.S. market. Moreover, since the alternative to the Agreement was an environment of increasing U.S. protectionism through the use of often capricious trade laws and other regulations affecting imports, these smaller firms should benefit immensely from free trade.

Second, there are corporations in import-competing sectors that will need to adjust to free trade. Here, however, adjustment will be minimized, since most of these sectors were able to obtain exemptions from the Agreement through the SAGIT consultative process. Examples of exempted sectors include the cultural industries, beer, and much of agriculture, where all marketing boards were maintained and quotas retained to keep out foreign suppliers. Even in textiles and apparel, the negotiators took steps to minimize the adjustment problem through long phase-ins of tariff reductions, discussion of special provisions on duty remission for imported fabric from third countries, and related measures.

The implication of this analysis of the issue of corporate adjustment may be surprising. There is no adjustment problem for efficient firms. All sectors of Canadian business can utilize the Agreement's phase-in provisions to restructure and organize themselves for expanded economic activity in a formally recognized North American market.

Strategic Management and Trade Liberalization

The process of strategic planning follows patterns in which the competitive strengths of the corporation are constantly reassessed in light of new information about the domestic and international envi-

ronments within which the firm operates. Such environmental changes include trade liberalization measures, to which the firm must react.[1] Here, we apply this process of competitive strategy to discover the basic principles involved in how firms will react to the fundamental changes in the Canadian-U.S. trading relationship that the Agreement will bring about.

Multinational enterprises account for about 70 percent of all trade between Canada and the United States, so the manner in which they will adjust to such a comprehensive trade deal is of paramount importance. Their internal managerial decisions also will have profound repercussions on the employment, social, and political aspects of the Agreement. In this study, we shall focus our attention on the behavior of Canadian and U.S. multinationals operating in Canada.

By definition, strategic management decisions take place under conditions of uncertainty and partial ignorance; consequently, the analyst cannot easily understand or program them. Investment decisions are especially important to model. Several authors have investigated the international dimension of business strategies based on the concept of internalization theory.[2] This theory is based on the idea that markets and hierarchical structures (firms) are alternatives: a product or service will be provided if it can be produced at a cost less than that involved with an open market transaction.

Internalization allows a multinational to establish and retain proprietary rights over its firm-specific advantages (FSAs) so that they cannot be dissipated to other firms. FSAs are defined as the competi-

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[1]For recent syntheses of this process of competitive strategy, see Michael E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Macmillan, 1980); and idem, *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Macmillan, 1985). For applications in an international dimension, see Alan M. Rugman, "Multinationals and Global Competitive Strategy," *International Studies of Management and Organization* 15 (Summer 1985): 8–18; and Michael E. Porter, ed., *Competition in Global Industries* (Boston: Harvard Business School Press, 1986).

[2]For an explanation of the behavior of multinational enterprises in a Canadian context, see Alan M. Rugman, *Multinationals in Canada: Theory, Performance and Economic Impact* (Boston: Martinus Nijhoff, 1980); and idem, *Inside the Multinationals: The Economics of Internal Markets* (New York: Columbia University Press, 1981).

tive strengths of the company, whether these are derived from production (R&D-based) or marketing (customization) advantages. Profitability and growth may also result from country-specific advantages (CSAs). CSAs capture a country's endowments of factors of production such as labor, capital, resources, and the quality of its economic, social, and political structure. CSAs are related to inputs in terms of their quality, quantity, and costs relative to those of other countries. They also include tariffs, nontariff barriers, and other government barriers to trade, such as regulations on foreign direct investment.

Internalization theory suggests that, for the internationally competitive operations of multinationals, the overall impact of bilateral trade liberalization will be positive. Its main effects will be to reduce transaction costs associated with exports and to create more certainty for investment decisions. In cases where foreign direct investment and exports are complements, bilateral trade liberalization should increase the level of both.[3] A substitution of exports for foreign direct investment can be expected in cases where tariffs and regulations on trade are the main rationale for engaging in foreign direct investment and where exit barriers are low; then, the adjustment costs of relocating production activities will be limited.

An important implication can be drawn from this analysis. A reduction in trade barriers need not have an important effect on a multinational's strategic management decisions. Trade barriers represent only some of the environmental variables that strategic planners take into account. Other factors, such as the need for property rights over knowledge, marketing information, and so on, are not affected at all by trade liberalization.

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[3]See A.E. Safarian, "The Relationship between Trade Agreements and International Direct Investment," in David W. Conklin and Thomas J. Courchene, eds., *Canadian Trade at a Crossroads: Options for New International Agreements* (Toronto: Ontario Economic Council, 1985).

Corporate Adjustment and Competitive Strategy

Michael Porter has argued that firms can develop three, internally consistent, generic strategies: overall cost leadership, differentiation, and focus.[4] Porter's model is strongly related to internalization theory, with its focus on FSAs and CSAs for the multinational. Multinational enterprises can attempt to turn their CSAs and FSAs into profitability and growth through the use of any of these competitive strategies.

The first strategy, achieving overall cost leadership, requires an organizational emphasis on the cost control of inputs and a production process that allows firms to obtain economies of scale. The differentiation strategy, on the other hand, requires the creation of products and services that customers perceive as unique. It emphasizes marketing aspects to gain competitive advantages. Focus, the third generic strategy, is aimed at serving a particular segment of the market, such as a narrow geographic area, a well-defined buyer group, or a limited product line. The competitive strengths of a firm engaging in the focus strategy also rest on its ability to achieve low costs or differentiation, but only vis-à-vis the chosen market segment. This strategy, by definition, limits the overall market share that is achievable but may still generate above-average profitability.

Each of the three general strategies can be seen as a set of defensive or offensive actions aimed at deriving profits and growth from the multinational's CSAs and FSAs. Whether a trade agreement between two countries strongly affects the structure of competition in an industry depends on entry and exit barriers, in addition to the CSAs and FSAs of the firms involved.

Entry barriers refer to the difficulties that firms face when trying to enter an industry or a new market. Porter identifies seven key entry barriers: economies of scale, product differentiation, capital requirements, switching costs, distribution channels, cost disadvantages independent of scale, and government policy.[5]

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[4]Porter, *Competitive Strategy*, provides a framework for analyzing industries and competitors and describes these three generic strategies.

[5]Ibid.; and idem, *Competitive Strategy*.

The important issue for managers of multinationals involved in adjustment within the Canadian economy is whether the introduction of a bilateral trade agreement will result in:

- *a status quo*, because the decrease in entry barriers — in this case, tariff and nontariff barriers to trade are the equivalent of Porter's government regulation — for a foreign firm is insufficient to allow entry into Canada;
- *new entries of foreign firms*, because the decrease in entry barriers is so substantial that it provides the economic impetus for entry into Canada; or
- *an increase in entry barriers*, because existing firms can now expand and profit from new environmental conditions leading to economies of scale.

Trade liberalization may weaken the competitiveness of some multinational firms' Canadian operations. For such firms, exit barriers are important. The main question then is whether decreased profits will result in divestment. There are six exit barriers that may prevent a firm from leaving the market: durable and specialized assets, fixed costs of exit, strategic exit barriers, information barriers, managerial or emotional barriers, and government and social barriers. If any of these exit barriers is high, the firm may decide to maintain operations that would otherwise have been closed down. A change in generic strategy may then be required to restore profitability.

The influence of entry and exit barriers on the strategic adjustment behavior of multinationals operating in Canada will be discussed in the next sections. Two elements, however, should be emphasized. First, Canadian economists have focused on an increase in entry barriers resulting from scale effects,[6] and have demonstrated that bilateral trade liberalization will allow Canadian firms to increase their production efficiency by serving the much larger U.S.

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[6]For a summary, see Canada, Royal Commission on the Economic Union and Development Prospects for Canada (Macdonald Commission), *Report*, vol. 1 (Ottawa: Supply and Services Canada, 1985), Chapter 6.

market. Second, there is what is known as the "asymmetry argument", whereby Canadian firms wishing to develop activities in the United States will face much higher entry barriers than will U.S. firms wanting to enter the Canadian market.[7] U.S. firms view Canada as an "incremental" market, which can be penetrated at low cost, while Canadian firms face a U.S. market that is ten times larger than their domestic base. For Canadian firms, entering the U.S. market will involve substantial investments, especially in marketing.

The Global Matrix and Strategies of Multinationals

To understand the manner in which multinationals can respond to trade liberalization, we need a conceptual framework that ties together national and enterprise influences on global strategic management. This can be achieved by combining country- and firm-specific advantages in a matrix, as demonstrated in Figure 1.

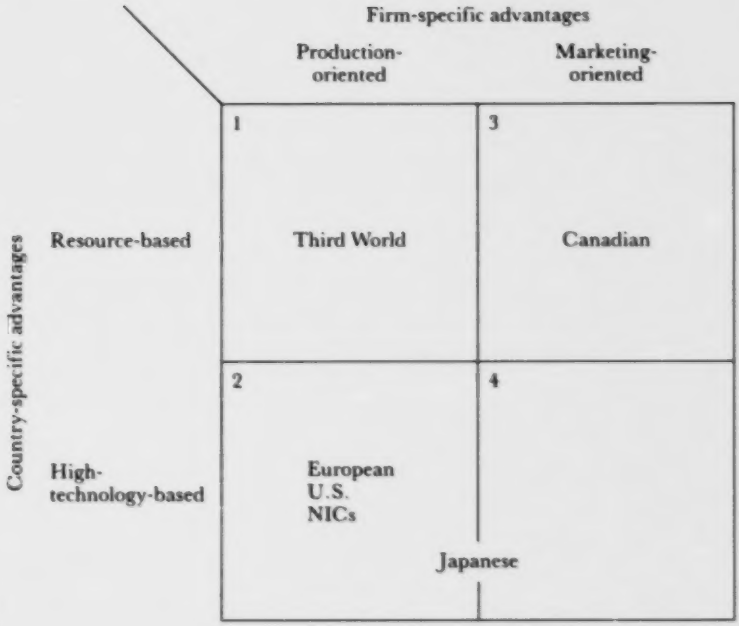
The vertical, CSA axis is divided into resource-based and high-technology-based advantages. Toward the top of this axis, a country's competitive advantage in resources is paramount, with relative factor endowments being the source of its comparative advantage. Toward the bottom of the axis, a country's competitive advantage increasingly is based on high-technology products, rather than on resources. This distinction is important, as changes in trade policy can influence high-technology CSAs. Yet, when resource-based CSAs dominate, a change in trade policy may not exert any major negative influence on the competitive strengths of the multinationals involved.

The horizontal, FSA axis in Figure 1 is functionally determined by the broad characteristics of enterprise structure, moving from a production-oriented FSA on the left toward a marketing-oriented service FSA on the right. Production-oriented FSAs basically reflect efficient cost-minimizing economic decisions. Enterprise strategies will be based on low costs and prices. Some firms achieve production-oriented FSAs through vertical integration, the use of process technology, and economies of scale. On the other side of this axis,

[7]See Richard G. Harris, "Comments," in Deborah Fretz, Robert Stern, and John Whalley, eds., *Canada-United States Trade and Investment Issues* (Toronto: Ontario Economic Council, 1985): pp. 64–68.

Figure 1

The Global Matrix



marketing-oriented FSAs reflect micromanagement skills in the organization of human resources, customization, cooperative relationships with suppliers and customers, marketing networks, and control over the channels of distribution. Enterprise strategies on this side of the FSA axis involve overall differentiation or focus differentiation, based on the gathering of customized intelligence.

Using this matrix, any multinational enterprise can be positioned in its current strategic spaces. Most are in quadrant 2, where rivalry is fiercest. Recent research[8] demonstrates that most Canadian

[8]See Alan M. Rugman and John McIlveen, *Megafirms: Strategies for Canada's Multinationals* (Toronto: Methuen, 1985).

multinationals operate in quadrant 3 rather than in 1; they have developed a value-added chain in the harvesting, processing, and marketing of resource and mature product lines. As Canadian multinationals expand, mainly as a result of natural CSAs, freer trade between Canada and the United States will allow them to exploit these natural CSAs further, without substantial influence being exerted on their production operations. This will strengthen them compared with Third World rivals that still compete in price by following a pure production-based strategy.

Figure 1 also allows us to observe that most Canadian multinationals pursue a differentiation strategy. It should, however, be considered as a focus differentiation strategy rather than as an overall differentiation strategy. This is because the segment scope (the number of segments served in an industry) of most firms is rather limited. The fact that most Canadian multinationals pursue focus differentiation strategies is extremely important. The Agreement's elimination of unnatural market imperfections will not substantially decrease the main entry barriers that foreign competitors face — namely, product differentiation, buyer switching costs, and access to distribution channels, a result which is somewhat in contradiction with the asymmetry argument. Most Canadian subsidiaries of U.S. multinationals operate in quadrants 1 or 3 of Figure 1. This means that they do not rely on high-technology CSAs.

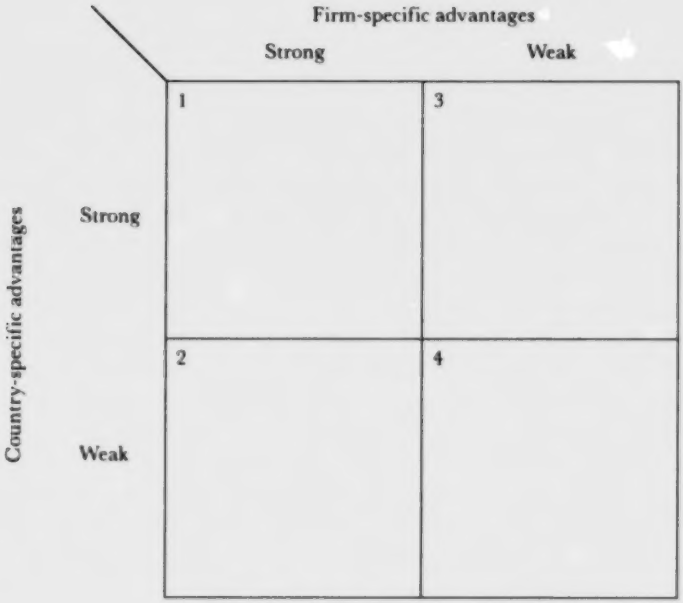
In order to predict in detail the influence of free trade on the competitive strategies of business firms, the analysis made above must be extended, for two reasons. First, it reflects only the operations of multinationals with strong firm-specific advantages and not other types of operations. Second, it does not describe the effect of a change in tariff barriers and regulations on high-technology or artificial CSAs and, thus, on the strategies of business firms that derived their competitive strengths from protection. In the next section, we develop a new framework to perform such an analysis.

Trade Liberalization and Competitive Strategy

In the context of bilateral trade policy, it is necessary to know how the introduction of trade liberalization will influence the investment

Figure 2

The Competitive Advantage Matrix



behavior of different categories of firms. Conceptually, we can analyze whether Canada possesses "strong" or "weak" CSAs and whether Canadian firms have strong or weak FSAs. A strong CSA or FSA is an advantage sufficient to ensure competitiveness as compared with foreign rivals. A weak CSA or FSA is an advantage that, in itself, is insufficient to allow competitiveness and profitability in the international marketplace. Any firm can then be placed in one of the quadrants of Figure 2.

This diagram models a firm's international competitiveness in terms of the strengths of CSAs and FSAs. Competitiveness is assured whenever FSAs and CSAs are strong simultaneously (quadrant 1). If CSAs are weak, however, FSAs will have to be substantial if the firm

is to compete with global rivals (quadrant 2). Similarly, if the firm does not possess strong FSAs, then strong CSAs are required to assure competitiveness (quadrant 3). If both CSAs and FSAs are lacking or restricted, it is difficult for such firms to compete internationally with efficient foreign rivals (quadrant 4).

The Canada-U.S. Free Trade Agreement will have different effects on the investment behavior of different categories of businesses in Figure 2.[9] If one classifies the largest Canadian multinationals and the largest subsidiaries of U.S. multinationals — that is, the billion dollar club — into the four quadrants of Figure 2 and evaluates their probable responses to the Agreement, one can make a distinction between six different cases. In four cases, firms classified in a particular quadrant before trade liberalization remain in that same quadrant after the Agreement. In two additional cases, firms that have used strong *artificial* CSAs to be competitive will now incur adjustment costs as they shift to a quadrant with weak CSAs.

The first case consists of firms located in quadrant 1, for which the Agreement will have little effect or, by reducing trade barriers, will strengthen their competitive position in the bilateral trade area. In this case, the potential effects will be an increase in domestic investment and some substitution of exports for foreign direct investment. Such a situation can be expected for most Canadian resource-based multinationals, especially in global industries, that possess strong FSAs and CSAs independent of protection. Examples include firms in the pulp and paper industry (Abitibi-Price, Consolidated-Bathurst, Domtar, MacMillan Bloedel), in energy (Nova and Gulf), and in the mining and metals industry (Noranda, Alcan, Falconbridge, and Cominco). Several of these mature, resource-based firms may now be in quadrant 3, but the Agreement offers them the chance to move to quadrant 1.

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[9]The discussion in this section draws on results of empirical research reported in Alan M. Rugman, *Trade Liberalization and International Investment* (Ottawa: Economic Council of Canada, April 1988).

The same observation holds for subsidiaries of foreign multinationals with world product mandates[10] or globally rationalized businesses. Since their parents possess strong FSAs, both categories of subsidiaries are able to compete efficiently on an international scale. At present, world product mandates in Canada are restricted mainly to vertically integrated multinationals that operate in this country to take advantage of the processing and marketing of Canada's natural resources. Common examples are to be found in minerals, forestry, agriculture, food processing, and other related areas. Globally rationalized businesses typically produce only a limited fraction of the total product line of a multinational for the world market. Unlike subsidiaries with world product mandates, they are essentially production driven and concentrate on low costs.

Finally, there are the branch plants of foreign multinationals. If they are efficient firms now operating to service the Canadian market for reasons of customization, machinery, or low cost, then they will retain their competitive advantages after trade liberalization. It appears that most of the larger Canadian subsidiaries of U.S. multinationals are such branch plants — those in the automobile sector, the oil sector, and in distribution, for example. These subsidiaries are internationally competitive firms that derive their competitive strengths from the FSA of their U.S. parent.

The second case consists of firms that are now located in quadrant 1 of Figure 2, but that will shift to quadrant 2 because of trade liberalization. These operations derive part of their competitive strengths from strong artificial CSAs — for example, they are sheltered from international competition by tariffs. The introduction of a bilateral trade agreement would eliminate such advantages.

Firms in this second category are likely to respond in one of three ways: by holding to the status quo, because strong FSAs combined with high exit barriers will compensate for the decline in CSAs; by

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[10]A world product mandate can be defined as the full development, production, and marketing of a new product line in a subsidiary of a multinational. See Alan M. Rugman, "Multinational Enterprises and World Product Mandates," in Alan M. Rugman, ed., *Multinationals and Technology Transfer* (New York: Praeger, 1983), pp. 73–90.

restructuring, which would be a major change in generic strategy; or by relocating their activities, if exit barriers are low. The latter two situations will apply primarily to a limited set of subsidiaries of U.S. multinationals — those that were set up as tariff factories to serve the Canadian market because of the high costs associated with trade, but that are not efficient enough to compete successfully in a free trade area. If exit barriers are sufficiently high to prevent the firm from relocating, it may have to change its generic strategy to maintain profitability. Firms that successfully pursued strategies of overall cost leadership or differentiation before the introduction of trade liberalization will no longer be able to do so in a more global environment. For such firms, a focus strategy then becomes necessary. This may take the form of global rationalization, whereby the product scope of the subsidiary is restricted. FSAs of the parent company then make international competitiveness possible.

It is apparent, however, that none of the largest Canadian subsidiaries of U.S. multinationals[11] falls into these categories of subsidiaries. This is consistent with the observation that the successive reductions in protective tariffs since the Second World War have not generated any substantial withdrawals of U.S. subsidiaries from Canada.[12] Changes in strategy may be necessary, however, for certain operations of Canadian multinationals where regulated domestic markets were an important factor for success. Some firms in the beverage industry, such as Labatt and Molson, fit into this category, as may Magna, the auto parts maker.

The third case consists of firms located in quadrant 3 of Figure 2, for which trade liberalization constitutes primarily a decrease in trade barriers. These firms will not expand, however, because of weak FSAs. In this case, no effects on investment behavior can be expected. This case primarily applies not to multinationals but to businesses of local Canadian firms that do not face global competitive pressures from foreign firms, either because of the multidomestic

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[11]That is, none of the billion dollar club of large multinationals analyzed in Rugman, *Trade Liberalization and International Investment*.

[12]See Macdonald Commission, *Report*, vol. 1; and Safarian, "The Relationship between Trade Agreements and International Direct Investments."

character of the industry or because a nationally responsive strategy[13] constitutes a viable focus strategy. Examples occur in resource-based sectors where production is mainly for domestic consumption — such as the inshore fisheries, small forestry operations, some agriculture, and related areas that do not depend on marketing boards for protection. This quadrant may, however, also describe a limited set of operations of Canadian multinationals, especially in mature industries, where FSAs have been eroded over time by competitive strategies of efficient foreign rivals, so that a free trade area is not considered to be important market opportunity.

The fourth case is that of firms that are now located in quadrant 3, but that will shift to quadrant 4 because, for them, the Agreement constitutes primarily a decrease in protective CSAs. These firms will be forced either to divest or to restructure their businesses in Canada (a change in generic strategy). Again, inefficient local Canadian producers that were sheltered from foreign competition through trade barriers may now be forced to exit, depending on exit barriers, unless they are able to develop new FSAs and adopt a focus strategy that can be sustained against competition. Examples occur in the feather, egg, dairy, and related industries protected by marketing boards. In all these areas, exit barriers for local firms and entry barriers for efficient foreign competitors are low. Only where protective mechanisms such as marketing boards are kept, and hence excluded from the Agreement, will such businesses survive. It also applies to certain operations of Canadian multinationals that have been economically viable only because of a protected Canadian market, such as those in the food-processing industry.

The fifth case is that of firms already in quadrant 2, for which the Agreement may have the effect of accelerating their relocation to countries with high CSAs. This case is similar to case 2 above. It can be expected, however, that multinationals in this quadrant already have diversified their geographic scope and/or will not be affected at all by a free trade area. Examples of such firms are Seagram, in the beverage industry, and Moore, in the technology-intensive information systems industry.

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[13] As described in Porter, ed., *Competition in Global Industries*.

Finally, the sixth case consists of those firms already in quadrant 4, for which the introduction of trade liberalization could speed up the divestment process. This quadrant basically describes inefficient operations of any type of firm, whether they are multinational or local. Exit will again depend on exit barriers' being low. Certain operations of a firm such as Varity (Massey Ferguson) may fall into this quadrant. Other examples include the obsolete plants of Goodyear and Firestone, which were doomed to close with or without the Agreement.

Conclusion

In this paper, we developed a new framework to gain conceptual insights into the effect of free trade between Canada and the United States on the strategies of large corporations, particularly multinational enterprises. A matrix (Figure 1) makes it possible to classify the efficient operations of multinationals according to the nature of their firm-specific and country-specific advantages. We then extended this framework (in Figure 2) to analyze the effect of a change in one particular aspect of a country-specific advantage — namely, trade policy — on efficient and inefficient operations of multinational enterprises.

We found that most Canadian operations of Canadian and U.S. multinationals will maintain their competitive strengths after the Canada-U.S. Free Trade Agreement is implemented. However, some operations of multinational enterprises (especially those with weak firm-specific advantages) will have to engage in strategic changes to minimize adjustment costs. The strongest policy implication of this paper is that corporate adjustment is really a nonissue. The multinationals themselves can adjust to the Agreement through their ongoing strategic planning. Well-managed corporations already exercise thoughtful strategies; efficient Canadian companies, both large and small, are already preparing themselves for free trade.

Structural Effects of Free Trade

David Rutenberg

Introduction

Different situations call for different analytical tools. The discussion of free trade began by using the law of comparative advantage, and proceeded to the development of econometric models of Canada and the United States. Now, the analysis needs to shift from using econometric models to using microstructural models of each industry. Consider the following two examples.

Ontario Hydro, in a presentation to the Ontario Energy Board, stated that free trade will result in a 1 percent increase in GNP, which means a 1.3 percent increase in electrical power requirements. Ontario Hydro now is having to analyze the detail of whether its transmission corridors are patterned appropriately, given that some industries will boom and others will wither, with the consequence that certain regions will require electrical power more rapidly than will the province as a whole.

A second example of a micro need is that the research departments of brokerage firms want to help their clients forecast which companies will rise and which will fall as a result of free trade. Brokers have not issued such advisory sheets yet — although everyone agrees that something is going to happen, there is not yet a methodology for making the predictions.

The conventional analytical tool is an econometric model that is used to predict half a dozen aggregate variables. These variables are entered into an input/output model that is then used to predict the consequences of changes in the variables on different sectors, or industries, of the economy. Unfortunately, an input/output model works best as a model of a closed economy — where, for example, an increase in the demand for steel results in the need for more steel mills, the construction of which requires cement, steel, and many other inputs. When both imports and exports are expected to increase due to a reduction in tariffs, the increasing demand for steel could be met by imports, or the new steel mills could be sized for export, or the cement and steel needed for the new mills could be imported. The extent of the change is merely a conjecture. Economists use the term "impact multiplier" as the total dollar effect on the economy of a one dollar change in a sector (steel, in this example). Impact multipliers are calculated in the inverse of an input/output table. Free trade reduces the impact multipliers.

Multinational Strategic Planning of Manufacturing

Plant location decisions center around a tradeoff between economies of scale and the cost of logistics — that is, the sum of import duties, freight, insurance, and the cost of pipeline inventory, minus export incentives. Currently, the cheap availability of ocean transport, the empty bellies of wide-bodied airliners carrying tourists, and the computer control of inventories have meant a steady reduction in logistics costs. Tariff cuts from successive rounds of multilateral trade negotiations have further reduced them. For most manufactured goods, it might appear that economies of scale so dominate logistics costs that the entire product line can best be serviced from one plant. Exceptions occur where the product is bulky compared to its value, since ocean and air freight are more usually volume limited than weight limited. Examples of such products are light bulbs, fiberglass insulation, and disposable diapers.

Where a corporation has multiple plants, the emerging practice is to differentiate each from the others; each has its own focus or role. Three Canadian-U.S. examples illustrate this point.

Example 1: Northern Telecom's PBX

A digital private branch exchange, or PBX, is a computer. Assembled from modules, small PBXs are the size of a desk, while large ones, capable of handling 1,000 lines, occupy a wall. Northern Telecom Limited has two PBX manufacturing plants, a large one in Santa Clara, California, and a small one in Belleville, Ontario. Even though the PBXs produced in the two plants appear to be the same, each plant has quite a different focus.

The Santa Clara plant produces a standard design PBX; its software accords only to North American Bell System standards. The Belleville plant produces all the special orders, such as export orders. Because the Belleville plant produces to such a variety of national specifications, its software department is much larger than that of the Santa Clara plant. By isolating complexity in Belleville and providing the necessary product and software engineers, Northern Telecom has permitted its manufacturing process engineers to make the Santa Clara plant a low-cost, focused factory. Free trade will lower the cost of components for the Belleville plant, but that plant's lack of focused volume will mean that it will always have higher unit costs than the Santa Clara plant.

Example 2: Alcan Rolled Products

By far the largest tonnage of rolled aluminum is used to make cans for beer and soft drinks. The alloy must be malleable for forming the can, so that the walls can be thin, and the wall surface must be suitable for printing. No flaws are permitted. This suggests the need for a dedicated plant, and Alcan Aluminium Limited has decided that its facility in Oswego, N.Y., is such a plant.

Alcan also has a rolling mill in Kingston, Ontario, next to Alcan's research lab, which itself has an experimental can-making line. The Kingston mill rolls aluminum of all kinds of alloy, all kinds of heat-treating sensitivities, and a wide range of surface finishes. When orders for can stock exceed the capacity of the Oswego plant, the Kingston plant rolls the excess. Psychologically, Alcan already views North America as an integrated market and network of rolling mills. Although Alcan Aluminium has its headquarters in Montreal, Alcan

Rolled Products coordinates North American rolled products from an office in Cleveland, Ohio. For Alcan, free trade between Canada and the United States will mean a minor reduction in the logistics costs of shipping from some plants to certain markets. But these reductions will not alter significantly the allocation of products to mills.

Example 3: Litton's Production of Inertial Navigation Systems

The manufacture of inertial navigation systems requires the ability to machine to a mirror-grade finish; this applies to both gyroscopic and laser systems. Litton manufactures inertial navigation systems in Los Angeles and Toronto. Both plants are equipped with modern machinery, but their work forces are quite different. In Toronto, Litton is the only employer of flat-mirror machinists, so job turnover is low. The Toronto plant is organized into work groups, and individuals of the same title know and respect one another's uniquely different abilities. When a navigation system comes back for scheduled overhaul, for example, the team that originally assembled it get to overhaul it — when they assemble, they do so with the expectation that this particular system will return to their desk annually for the next 20 years. In contrast, the Los Angeles plant suffers so much job turnover that a system has to be subdivided among different work stations, each of which is designed to be quick to learn.

Litton sends commercial inertial navigation systems to Toronto, because continuity of overhaul reassures customers. It used to send all military work to Los Angeles, until the U.S. Department of Defense permitted the Toronto plant to be a competitive second source for cruise missile navigation systems. In this open competition, Toronto frequently beat Los Angeles on quality and cost, although U.S. Defense Department procurement regulations safeguard some orders for the prime contractor — that is, the Los Angeles plant. Because of the Defense Production Sharing Agreement, there has been free trade in military equipment since the 1960s, so the Canada-United States Free Trade Agreement will have no effect in this area, except to reduce the cost of components that the Toronto plant purchases in the United States.

Summary

In each of these three examples, economies of scale dominate logistics costs. The world market, and certainly that of North America, can best be served by one plant. A small plant located in Canada can be viable, however, if the company manufactures multiple products. The company can increase the efficiency of its manufacturing system by simplifying the product line at one plant and by assigning product complexity to the other. Usually, the U.S. plant focuses on cost-minimizing standard products, while the Canadian plant focuses on coping with the complexity of variety. Coping with variety requires flexibility. This is possible only if there is a substantial real investment in human capital. It also requires a cost-accounting system that encourages — or at least measures — the capability of flexibility. For example, computer-assisted design and manufacturing systems rarely appear justified in conventional accounting systems, and orthodox cost accounting of unit costs usually would reward the inflexibly focused plant for its apparent low costs. Multinationals that already have plants in Canada probably will change the focus of these plants, as Northern Telecom, Alcan, and Litton have already done. It is possible to locate a flexible plant anywhere, and although some new flexible plants are being constructed in Canada, most are evolutions of existing branch plants.

Multinational Strategic Planning of Marketing

No multinational has the resources to cover the world evenly with its product. Each has constraints on executive talent or capital. Global marketing strategists thus divide the world into opportunistic markets and strategic markets — of which there are only a few. Most corporations have an ethnocentric view of the world, seeing their home market as strategic and all others as opportunistic.

This view is encouraged by government export incentive programs, which might support a single visit to an overseas, opportunistic market as part of a trade mission. In contrast, strategic marketing involves the decade-long systematic invasion of a country, dislodging competitors one at a time so as to achieve market share dominance.

One purpose of opportunistic selling is to buy information. Since

companies lack the resources to take on more than a few strategic markets simultaneously, global market analysts need to develop a list of such markets, ranked in the order in which the invasions will be conducted. Information for that ordering comes from opportunistic selling. For many Canadian multinationals, the many recent immigrants to Canada make opportunistic selling comparatively easy. They know the language back home, and some have relatives in powerful positions in the customer organization.

Canadian companies without international experience would be wise to select the United States for their first strategic expansion abroad. A generation ago, Canadian executives may have been more comfortable in Britain than in the United States, and before Britain joined the European Community, the Commonwealth Preferential System meant that Britain imposed low tariffs on Canadian goods. That bias has passed away, and most Canadian business executives now think of the United States as a more familiar market.

There are, however, more significant differences between the U.S. and Canadian business systems than most Canadians realize. First, the U.S. system is much more legalistic. U.S. Department of Defense procurement regulations, for example, require that a bid be responsive to every clause of the Request for Proposal. A bid that offers to trade off more on some requirements for less on others, as is typically the case in Canada, is rejected without consideration. Similarly, in the United States, product liability cases involve much larger settlements than they do in Canada. This means that every item sold in the United States involves a latent liability against which the company should insure — alternatively, the company should increase the price of the product to self-insure, and view the funds as a reserve, not as profit.

Second, competitor analysis is done quite differently in the United States than it is in Canada. The military usage of threat analysis distinguishes between capabilities and intentions. In the United States, competitor analysis focuses on capabilities; hostile intentions are presupposed by the use of sports metaphors about winning. In Canada, business executives are preoccupied with understanding intentions; most Canadian executives know one another (or know someone who knows the competing executive). The size of Canadian

chartered banks also makes it comparatively easy for Canadian companies to obtain funding for any takeovers that make sense, thus further reducing the importance of capabilities in the Canadian context.

There may be rare instances when a Canadian company's global expansion plans for a product should willfully bypass the U.S. market. An example of a rare case occurs if U.S. competitors are already consolidated and preoccupied with their home market, while other important markets are fragmented; then it may make sense to invade somewhere else as a first foreign market. Canadians find it difficult to conceptualize focusing so narrowly as to dominate the U.S. market in a particular product, foregoing all the other burgeoning markets of the world until the U.S. market is theirs.

Unbundling Vertical Market Structures

The old Singer Sewing Machine Company was once so vertically integrated that it owned oak forests, and sawmills with which to make hardwood cabinets for its sewing machines. The need for vertical integration focuses on issues such as vulnerability to supply interruptions, legal remedies, and information impactedness — that is, the inability to write contingent contracts adequate for all outcomes.

Canada's small industrial base has meant that, for many industrial products, the whole Canadian market is barely large enough to support one producer. Though Canadian companies have a purchasing department for items supplied by multiple vendors, they also have a president-to-president relationship for those items that have one vendor. Instead of being vertically integrated, many Canadian corporations have networks of vertical *relationships*. Such relationships are certainly not uniquely Canadian, and can work very well if the mutual dependency is acknowledged. Sears, Marks and Spencer, and several Japanese corporations have decades of experience with such relationships. Free trade will permit Canadian businesses to consider new vendors, thus unbundling past relationships. Old vendors that are too slow to change their corporate culture likely will cry for transitional subsidies.

I expect to see Canadian companies increase their use of make-or-

buy analysis at each step of the manufacturing process. A company that has been purchasing brand name products will have to undertake a three-step process in its make-or-buy analyses:

- codify and refine engineering specifications;
- toughen the purchasing function, so that the purchasing department can negotiate with U.S. vendors and reject shipments that fail to meet its specifications; and
- increase its knowledge of global sources of production inputs.

Many current purchasing departments will be overhauled and enhanced. Those that are powerful and self-confident will recommend that old relationships be severed, that the company unbundle its own vertical integration and divest itself of links in its business that others can supply more cheaply. These decisions will not be made easily, for they will force executives to re-examine and redefine their company's core skills.

Many corporations are now cutting their headquarters' overhead costs. For example, they are beginning to compare the cost of maintaining in-house legal council with engaging outside law firms, the cost of in-house corporate strategic planning with the use of consulting firms that promise not only rigorous analysis but also help in implementing each recommendation, and the cost of conducting R&D with purchasing it elsewhere. The prime minister is urging that more R&D be conducted in Canada, but I do not believe that there has been enough analysis of the role of trade secrets in the viability of small, open economies. My belief is that corporate research by the dominant player in a global industry can be shared within a trade association or with universities. However, small niche players — the role that Canadian companies play in the international arena — can survive only by maintaining the strict secrecy of their research and development. I find it helpful to differentiate between universities and embassies, whose task is to monitor the world of research, and nondominant corporations, whose survival depends on extracting monopoly rents from secret knowledge. Adequate theories do not exist that will help a company to determine when it will gain by being secret and when it will gain by being open. (When IBM was open

about its PC architecture, it lost market share to clones; at the same time, it greatly expanded industry volume by encouraging software development.) Canadians have to think through what it means to operate in a small, open economy. For that purpose, our model should not be the United States but, rather, countries such as Austria, Denmark, and Singapore. (South Korea and the Netherlands are small countries dominated by their own multinationals, which is quite different from the Canadian case, and thus do not serve as relevant models.)

A Caveat: The Paradox of the Dutch Disease

Despite my belief that Canada will gain from free trade with the United States, I have a caveat on a topic about which no one has yet developed an adequate theory to guide our understanding: the relationship between unemployment and the exchange rate.

After natural gas was discovered off the coast of the Netherlands in the 1960s, pipelines were laid to West Germany. The export of natural gas creates few jobs directly, and the Netherlands was no exception. Unfortunately, Dutch natural gas exports had two insidious, indirect effects. First, they improved the Dutch balance of payments, which caused the currency to appreciate. Manufactured exports from the Netherlands became more expensive in terms of Deutschemarks, so sales to West Germany dropped, and Dutch workers were laid off. Second, the Dutch government, flush with natural gas royalties, stepped in with more generous and longer unemployment insurance, which reduced the monetary incentive to work. The Dutch habits of diligence and pride in work were undermined within a decade.

Multinational corporations, in trying to decide where in the world to build plants to serve their global markets, like to forecast labor wage rates a decade, even two decades, hence. In particular, they wish to avoid countries that might catch the "Dutch disease". According to two consulting firms in the United States, Bain & Co. and Braxton Associates, that have examined balance-of-payments theory, if a company wishes to locate a plant in an area where low real wage rates are assured, it should seek out countries that have no

natural resources to export, and that have such a fragmented industrial structure that no industry is likely to achieve world dominance. (Either raw materials exports or exports by a dominant manufacturer exports would cause the currency to appreciate.)

My concern with the Canada-U.S. Free Trade Agreement is that nobody understands the employment consequences of raw materials exports, which the Agreement will allow untrammeled. As a result, Canadian corporations will have to bargain hard to hold down Canadian wages, expressed in foreign currencies. Experts believe that the effect between the exchange rate and productive employment is sizable in Venezuela, Indonesia, and Norway, but not in Canada because of Canada's huge automobile exports. As Canada steps into a new relationship with the United States, the relationship between employment and the exchange rate will have to be monitored.

The Corporate Strategic Response to Free Trade

Erik G. Rule

Introduction

The Canada-U.S. Free Trade Agreement heralds a profound change in the business environment for Canadian firms. Such changes are nothing new. The 1970s saw the great oil price shock, followed by high inflation. Between 1975 and 1985, Canadians were subjected to increased regulation at the hands of such bodies as the Anti-Inflation Board and the Foreign Investment Review Agency, and to deregulation in sectors such as transportation and financial services.

Our knowledge of strategic management suggests that when the business environment changes, a company's competitive strategy should be re-examined and realigned as required to defend against new threats from competitors or to take advantage of new opportunities through offensive, business-building strategies.

The challenge now facing corporations in Canada is how to respond strategically to the new free trade environment. This paper examines, first, the key issues posed by the Agreement that Canadian-based corporations should consider in formulating their future strategic plans and, second, the likely changes in strategic direction that Canadian corporations will adopt to take advantage of this new trading environment.

The observations presented here are based on a recent survey carried out by The Coopers & Lybrand Consulting Group with a sample of senior executives in 124 Canadian corporations. The aim of the survey was to gain a better understanding of senior management's views on the two topics.

The companies surveyed represented a range of industry sectors, although the manufacturing sector dominated, with 65 percent of the respondents. The second-largest sector was services, with 18 percent of the respondents. Responding organizations also reflected both small and large enterprises. Forty-four percent of responding organizations had less than 500 employees, 40 percent had between 500 and 5,000 employees, and the remaining 16 percent had over 5,000 employees. Over 85 percent of the respondents were either chief executive officers or vice-presidents within their respective organizations; their responses, therefore, would seem to represent senior management points of view.

The next section discusses the key issues raised by the Agreement for the corporate strategies of Canadian firms.

Strategic Challenges Posed by the Agreement

The Coopers & Lybrand Consulting Group's understanding of the Agreement and analysis of the survey results indicates that the Agreement poses two key issues for Canadian-based corporations:

- the offensive strategies that will result in profit growth in both the Canadian and U.S. markets, and
- the strategies that will be required to defend existing market positions in the domestic Canadian market from expected new competitive entries.

Each of these key issues is explored below.

What Offensive Strategies Should Be Pursued?

Companies operating in Canada expect to prosper under the Agreement. Of the 124 companies surveyed, 60 percent indicated that they expect to benefit positively from the Agreement over the

next ten years. Only 10 percent expect to be negatively affected, while the remaining 30 percent expect little or no impact on their fortunes. In effect, there are five times as many expected winners as losers, according to these respondents.

Large companies, defined as those having more than 500 employees, are even more optimistic about their prospects under the Agreement than are smaller companies, with almost 70 percent expecting to be positively affected. These larger organizations appear to be confident that they are more likely to profit from economies of scale in the areas of manufacturing, market research and the gaining of competitor intelligence, and the establishment of their own direct sales force in the United States.

Given this level of optimism, the first issue facing Canadian corporations is the offensive strategies that are needed to capitalize on the expected freer access to lucrative U.S. markets.

What Defensive Strategies Should Be Adopted?

The second key issue emanating from the Agreement is the strategies Canadian-based firms should adopt to defend their market positions within the domestic market.

The Agreement is expected to result in a change in the relative power of buyers and suppliers in the Canadian market, as well as an increase in the number of new competitive entries in Canada from the United States and possibly other countries in the Pacific Rim and Europe. These factors will contribute to a tougher competitive environment in Canada.

Four factors likely will lead to an increase in competitive intensity:

- Increased competition in Canada from U.S. competitors. Most Canadian companies in the survey expect this competitive response to be the most likely outcome of the Agreement.
- New offshore competitive entrants from Europe and the Pacific Rim seeking to enter the North American market.
- An increase in the bargaining power of buyers in Canada as they expand their sourcing of raw materials, parts, and components from the United States. In many cases, this may require a significant

strengthening in the purchasing functions in these organizations.
- The compression of product life cycles as new technologies and substitute products are more readily transferred to Canada. Canadian firms thus will need to invest additional resources in R&D and to develop a better understanding of changing customer needs.

Two factors will contribute to a reduction in competitive intensity:

- A decline in the bargaining power of suppliers to Canadian customers due to improved access to U.S. suppliers.
- The distraction of domestic Canadian competitors from serving existing Canadian customers when they pursue U.S. market opportunities. This neglect may provide opportunities for share shift to occur in Canada.

On balance, these factors likely will result in a significant increase in competitive intensity in the domestic Canadian market as the Agreement is gradually implemented. Canadian companies will have to be on the alert to defend their domestic market positions in the face of these changes.

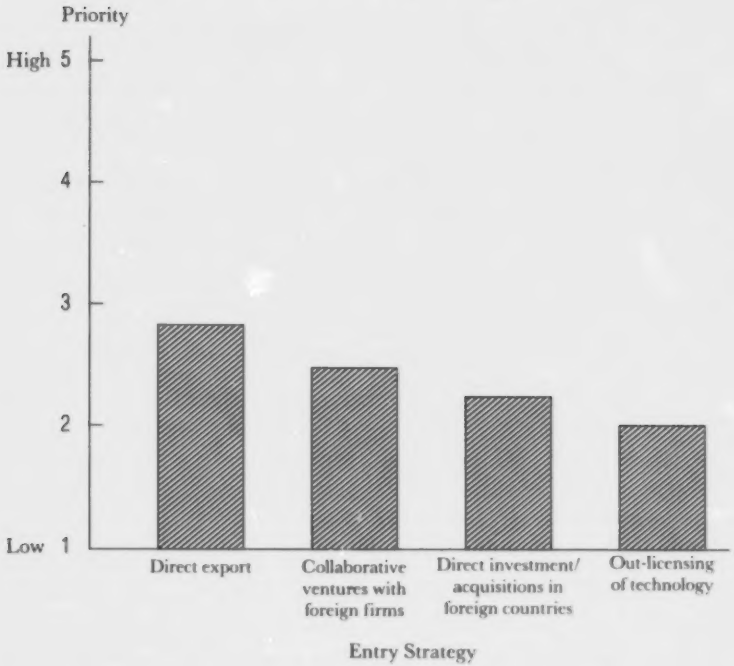
Entry Strategies to Penetrate the U.S. Market

In attacking export markets, corporations are able to draw on four fundamental entry strategies: direct export; the formation of collaborative ventures and strategic alliances with foreign firms; direct investment in plant and equipment in the target country; and the out-licensing of technology. Each strategy has its own set of inherent risks and rewards.

The corporations surveyed were asked to indicate the relative priority they intend to place on these strategies. Figure 1 summarizes these results. Of the four options, the respondents view direct export through a captive sales force or through agents as the preferred strategy for penetrating the U.S. and other offshore markets. Smaller companies and those that have not yet achieved a significant position in export markets report that they will place greater emphasis on direct exporting through a "rented" or agency sales force. It is also

Figure 1

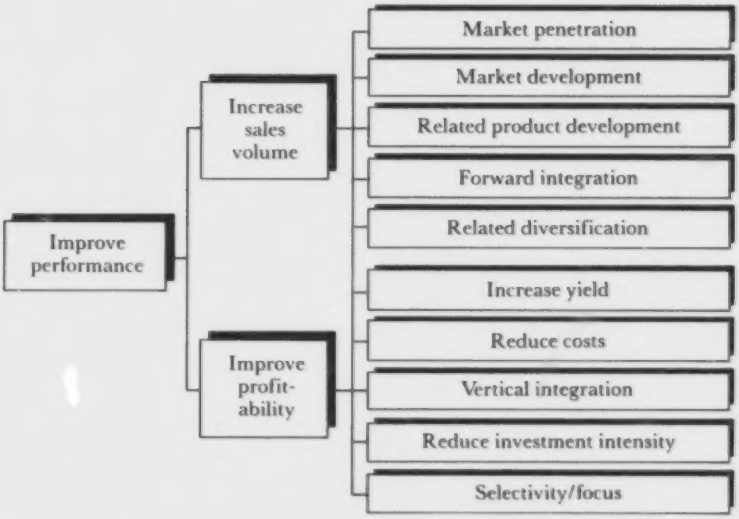
Priority Given to Global Market Entry Strategies



clear that many respondents are prepared to consider forming collaborative ventures with foreign firms, especially when the resources of the Canadian firm are limited or when there is a need to diversify to lessen the risks of the venture. The last two strategies, direct investments and out-licensing of technology, apparently will receive lower priority in competing in the U.S. market. Those companies that prefer the direct investment strategy tend to be larger firms having more than 5,000 employees.

Figure 2

Optional Strategies to Exploit Free Trade



Likely Competitive Strategy Responses

While Canadian-based corporations expect to give the direct export strategy to the United States a priority, a further consideration is the specific competitive strategies they will employ to achieve their strategic goals in the United States.

Improved corporate performance can be defined in terms of enhanced market position, increased return on capital employed, or creation of shareholder wealth. It can be achieved by increased sales volumes, by improved profitability, or by a combination of both. Supporting each of these two broad strategies are ten optional competitive strategies that corporations can use to capitalize on free trade with the United States (see Figure 2).

Our survey of corporations operating in Canada indicates which of these competitive strategies likely will receive priority in the free trade environment. Some of the more interesting findings follow.

• *Reducing manufacturing unit costs is key*. Only about one-third of the responding organizations believe that their products currently are cost competitive in international markets. This fact, combined with their recognition that many industries are becoming increasingly globalized, appears to be driving Canadian enterprises to re-examine their cost competitiveness within an international context.

Achieving cost competitiveness in manufacturing is the competitive strategy that will receive the greatest emphasis over the next ten years. This high priority is consistent across all categories of respondents, including large and small companies and Canadian and foreign-owned companies. The increased emphasis to be placed on unit cost competitiveness by foreign-owned companies indicates that these firms are intent on maintaining the viability of their Canadian operations, rather than allowing them to revert to being sales branches.

• *Innovative marketing and selling will be used to gain market penetration*. Companies plan to place greater emphasis on employing innovative marketing and selling approaches in penetrating the U.S. market over the next ten years.

Besides being litigious, the United States is a marketing-and-promotion-oriented society. Canadian business leaders, regardless of the size or country of ownership of their company, recognize that they must develop excellence in their marketing and selling functions in order to succeed in the competitive U.S. market.

• *Product development is a strategic priority*. Over the next ten years, the respondents see a higher priority being placed on the development of new and improved products and services to increase penetration of existing served markets. Companies with less than 5,000 employees view this as an even higher priority than those with 5,000 or more employees. All appear to be intent on competing with U.S. firms on an equal footing in terms of product line breadth, depth, and quality.

• *The business mix will remain broad*. Expansion into the U.S. market will alter the geographic business mix of companies. In addition,

respondents indicate that they plan to diversify their product line mix further over the next ten years. Specifically, responding organizations intend to place greater emphasis on developing new and improved products and services to increase penetration of existing served markets — which includes the United States when the respondent is currently an exporter — and on diversifying by pursuing new products or markets that are significantly different from those currently served.

Responding companies also indicate that they intend to place less emphasis on divesting business units that they judge to be uncompetitive or not strategically attractive.

This finding is inconsistent with current strategic thinking, which calls for product-market-niche strategies to be employed in attacking global markets. It is our view that for those Canadian companies which have relatively smaller economies of scale than their U.S. competitors, focusing on selected product market niches will be essential to success in the U.S. market. This is especially important because of the large size and complexity of the U.S. market. For example, the economic output of California is larger than that of Canada. California is expected to grow to be the fifth-largest economy in the world by the end of the century. We often counsel clients to approach the United States not as just one market but as a series of five or six regional markets, each with its own unique distribution channels, buying patterns, and competitive situation.

Conclusion

Companies operating in Canada view free trade as an important issue. They expect to alter significantly their corporate strategies to capitalize on the opportunities that free trade with the United States will bring.

Over 60 percent of Canadian-owned companies expect to benefit from free trade. While they anticipate facing increased competition in Canada from U.S. firms, they plan to respond strategically by:

- increasing their sourcing of raw materials from the United States;
- becoming more cost competitive in manufacturing;

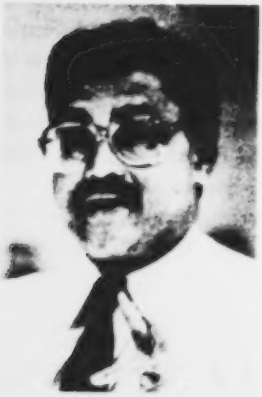
- placing a high priority on exporting directly to the United States using either their own sales force or one that is "rented"; and
- innovating in marketing and selling functions.

Subsidiaries of foreign companies operating in Canada view the free trade deal even more positively than do Canadian companies. They intend to respond strategically by:

- expanding their efforts to penetrate the Canadian domestic market;
- developing new and improved products and services;
- innovating in marketing and selling functions; and
- becoming more unit cost competitive in manufacturing.

In the long term, the success of Canadian companies both in the United States and in global markets will require greater confidence and commitment on their part. Our survey and discussions with Canadian companies indicates that they are increasingly committed to succeeding in the United States through the opportunities free trade offers. Initial successes in the U.S. market will help to build the confidence Canadian companies need if they are to compete in increasingly global markets over the next 20 years.

Strategies for U.S. Subsidiaries after Free Trade



Joseph R. D'Cruz

James D. Fleck

The Canada-U.S. Free Trade Agreement now before Parliament and Congress is likely to be of major historical significance. By eliminating tariff barriers between the two countries and placing important constraints on the ability of both governments to erect nontariff barriers, the Agreement could lead the way toward even greater economic integration in North America.

One group of businesses that will be directly and substantially affected by this development will be the Canadian subsidiaries of U.S. multinational enterprises. U.S. multinationals are being buffeted by the rapid globalization of the industries in which they participate. The progressive globalization of manufacturing is encouraging the development of new patterns of specialization in the geographic distribution of multinational production. The Canadian subsidiaries of U.S. multinationals will have to undertake significant restructuring to remain viable in the new forms of global competi-

tion.[1] This paper intends to show how these subsidiaries can take advantage of the Agreement as part of their strategy of adjustment to global competition.[2]

When the Agreement is a fact, Canadian plants will be evaluated on the same basis as U.S. plants. This will be a new and difficult situation for managers of Canadian subsidiaries. Until now, a key focus of the strategies of these subsidiaries has been to serve the relatively protected Canadian market.[3] Investments in plant and equipment have been evaluated mainly on the basis of prospects for sales in Canada. Since the Canadian market is about one-tenth the size of the U.S. market, sales volumes are relatively small. This is offset somewhat by higher prices made possible by the benefits of tariff protection and other trade barriers that successive Canadian governments have erected to foster the growth of a domestic manufacturing base.

As free trade becomes a reality, the rules of the game will change for managers of U.S. subsidiaries:

- They will face import competition from the U.S. plants of their corporate parents. These plants are designed to serve a much larger market and, consequently, are better able to take advantage of economies of scale. To be allowed to continue operations, the Canadian plants will be required to demonstrate that they can be restructured to become competitive with U.S. plants.
- Restructuring Canadian operations will call for large capital investments. In competing for capital with their U.S. counterparts,

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[1]For a good survey of the implications of globalization for U.S. firms, see Michael F. Porter, ed., *Competition in Global Industries* (Boston: Harvard Business School Press, 1986).

[2]For a detailed discussion of these issues, see Joseph R. D'Cruz and James D. Fleck, "The Globalization of Manufacturing," *Business Quarterly* 52 (Winter 1987/88): 42-51.

[3]Despite the rhetoric about "world product mandating", most Canadian subsidiaries of U.S. multinationals are mandated mainly for the Canadian market. For a discussion of the reasons why world product mandates are difficult to acquire, see Joseph R. D'Cruz, "Strategic Management of Multinationals," in Hamid Etemad and Louis Séguin Delude, eds., *Managing the Multinational Subsidiary* (London: Croom Helm, 1988).

however, Canadian managers will have to demonstrate that their plants can become competitive in quality and cost.

- Without access to the U.S. market, Canadian plants will be unable to achieve the scale economies needed to achieve competitive costs. Canadian subsidiaries then will have to prevail on their parents to grant them mandates to serve the U.S. market.
- Both Canadian and U.S. managers will have to become concerned with global competitiveness as their industries become increasingly global in scope.

To understand these issues better, we conducted an interview-based study of 25 chief executive officers of the largest Canadian subsidiaries in terms of employment. We limited our sample to subsidiaries in manufacturing. In addition, we also interviewed a number of U.S.-based executives in the home offices to which the Canadian executives reported.

We also interviewed experts in the financial services industries in New York, Chicago, and San Francisco who deal with U.S. foreign direct investment in Canada. We asked these experts for their views on the impact of the Agreement on investment flows. Here, too, concerns focused on the need to respond to the impact of international developments on the North American market.

The principal concern of our respondents was the impact of globalization on the viability of their businesses in Canada.

A consistent theme that emerged from the interviews is the respondents' concern about the need to respond to globalization of their industries. Thus, while the trade initiative provides the immediate impetus for specific changes in investment behavior, the overriding strategic concern is the viability of the subsidiaries in the face of the new forms of international competition that are emerging in their industries.

North American businesses can no longer confine their attention to the Canadian-U.S. market when addressing their future. The progressive globalization of the industries in which they compete has made it imperative for them to develop strategies within the context of

developments in the global marketplace.[4] The key challenges they face come from competitors located in Japan, Western Europe, and the fast-developing newly industrializing countries (NICs).

The manufacture of traditional labor-intensive products is no longer viable in countries that are members of the Organisation for Economic Co-operation and Development (OECD) because of the high cost of labor. Unless they are protected by trade restrictions — such as tariffs, quotas, and voluntary restraint agreements — such businesses will succumb to import competition. Initially, such competition was located in the NICs — Hong Kong, Taiwan, and South Korea, for example. Now, the NICs are coming under intense pressure from less-developed countries (LDCs) with even lower labor costs — Thailand and Sri Lanka, for example. As a consequence, the NICs are reducing their dependence on such industries and shifting into more capital- and knowledge-intensive industries. The resulting international division of labor has been likened to a cascade by the Japanese industrial strategist, Miyohei Shinohara.[5] Figure 1 shows the rapid development of this new pattern of global specialization.

The progressive globalization of manufacturing is encouraging the development of new patterns of specialization.

Much adjustment will be necessary for businesses located in OECD countries to cope with these changes. They will have to abandon domestic manufacturing in labor-intensive industries and the traditional capital-intensive industries. In addition, they will have to adapt to the new patterns of competition that are emerging in knowledge-intensive industries. These are the new global industries in which only competitors with global strategies can survive.

The driving force behind the globalization of the knowledge industries is the impact of economies of scale in the deployment of

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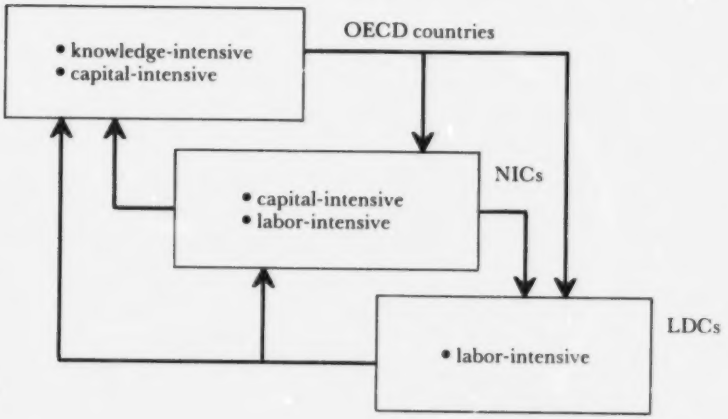
[4]See Theodore Levitt, "The Globalization of Markets," *Harvard Business Review* 61 (May-June, 1983): 92-102.

[5]Miyohei Shinohara, *Industrial Growth, Trade and Dynamic Patterns in the Japanese Economy* (Tokyo: University of Tokyo Press, 1982).

Figure 1

The Pattern of Global Specialization



knowledge-based products.[6] The cost of research and development of high-technology products is staggering, and must be incurred in advance of production. Manufacturing processes must be made increasingly capital intensive to remain competitive. At the same time, the lag between new product launches by innovators and imitation by competitors has been shrinking. It is becoming increasingly common, therefore, for new products to be launched on a global basis, instead of the traditional market-by-market roll-out that worked so well in the past. The cost of global launches creates further scale economy effects. Thus, economies of scale are a key force behind the globalization of the knowledge industries. The huge fixed costs of developing, manufacturing, and marketing knowledge-based products must be spread over large volumes in order to keep unit costs at a competitive level. Therefore, access to a large market is imperative for success in these industries.

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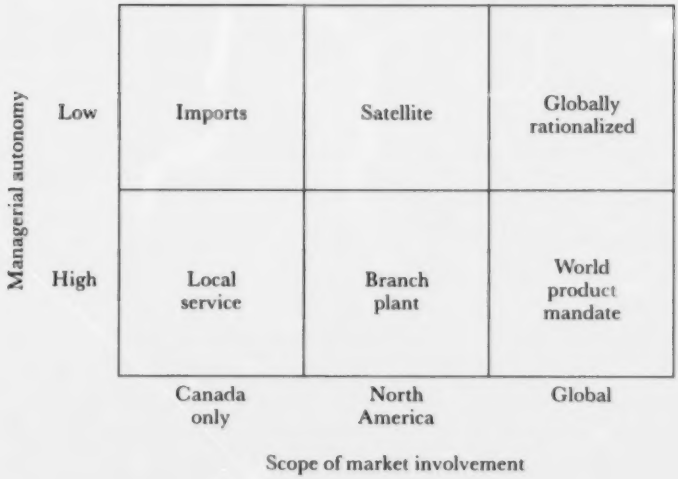
[6]See Paul A. Strassman, *Information Payoff: The Transformation of Work in the Electronic Age* (New York: Free Press, 1985).

Figure 2

The Subsidiary Mission Grid



U.S. multinationals will have to alter the missions of their subsidiaries in Canada as part of the process of adjustment to these global developments, just as they are having to restructure their domestic operations.

Many of the existing businesses in which the subsidiaries are engaged will be unable to meet import competition from non-OECD countries. And new businesses based on knowledge-intensive products will not be viable if they are based on serving the Canadian market alone. Therefore, the adjustment process will require new strategies involving a higher level of integration with operations in the United States.

To focus understanding of this adjustment process, we have found it helpful to use a device called the Subsidiary Mission Grid (see Figure 2). This was originally developed by Frank Tyaack, former chief executive officer of Westinghouse Canada, as an analytical tool

for strategic planning at the corporate level.[7] Subsequently, other U.S. multinationals have adopted similar approaches.

The grid is used to classify businesses on the basis of two factors: the level of managerial autonomy and the scope of market involvement. Let us now see how the grid is used.

Using the Subsidiary Mission Grid

The first step is to position each business unit of the subsidiary on the grid. The vertical axis shows the *degree of decisionmaking autonomy* of the business. It is divided into two levels. On the top are businesses with little strategic autonomy, where authority rests mainly with the home office; the subsidiary does not determine product or pricing policies, nor does it make decisions about technology, production policies, or marketing approaches. The lower level is used for businesses where major decisions of this nature are made locally, with some coordination with home office managers.

The horizontal axis, used to depict the *scope of market involvement* of the business, is divided into three zones. On the left are businesses that are concerned only with the Canadian market and that compete mainly with other businesses in Canada. The next zone represents businesses whose scope of competition is the Canadian-U.S. market. Finally, the zone on the right is used for businesses whose scope is global.

The six cells of the matrix describe different missions for a business unit of a subsidiary. They have been labeled according to the principal strategic characteristic of the mission.

Imports. Many businesses in this category are set up to sell new products not previously available in Canada. The subsidiary may sell directly or through agents, but it is totally dependent on the parent for products and technology.

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[7]See Joseph R. D'Cruz, *Strategic Management of U.S. Subsidiaries in Canada* (Ottawa: Institute for Research on Public Policy, 1985).

Satellite. The business that successfully imports eventually faces competition, and pressures develop to reduce costs. One way to accomplish this is to import subassemblies and put together the final product in Canada. Often, import duties on components are lower than duties on finished products. The satellite business will remain heavily dependent on the parent.

Local service. If an imports business faces nonprice competition, it may respond by expanding the local service content — training customers, repair and maintenance, and so on. To the extent that these businesses manage their own market linkages, they are granted a certain measure of managerial autonomy.

Branch plant. When both price and nonprice pressures combine, the subsidiary may convert the business to a branch plant — that is, a miniature replica of the parent's business. These businesses conduct final assembly in Canada and provide substantial local services to their customers. They continue to rely on the parent, however, for technology and components whose manufacture is subject to scale economies.

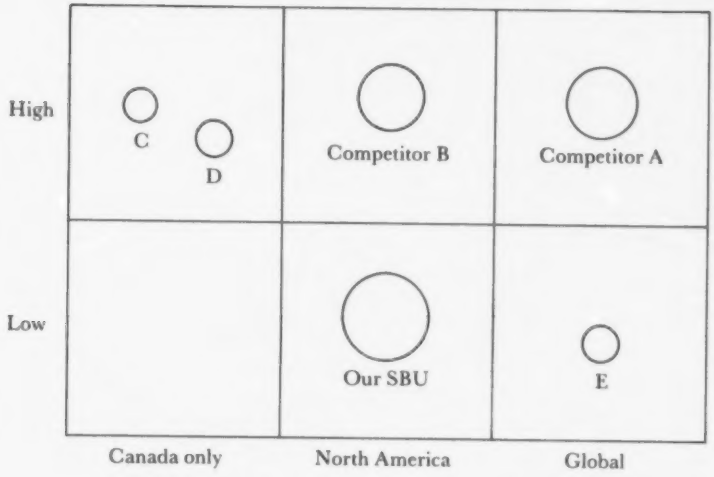
Globally rationalized. These businesses operate as part of a global business entity. The Canadian subsidiary is structured to supply a limited portion of the product range, with the remainder of its requirements being met by imports from plants in other parts of the world. Rationalization is primarily a production concept, designed to position the multinational as a low-cost, high-quality producer.

World product mandate. When the subsidiary assumes a home office function for a line of business, it is said to have acquired a world product mandate. The subsidiary assumes control for the fundamental technological thrusts that will sustain the competitiveness of the business. It makes decisions about the timing and direction of product development, and it is substantially involved in investment decisions about production facilities, marketing, and distribution.

The Subsidiary Mission Grid can serve two purposes. First, it

Figure 3

The Strategic Position of a Business



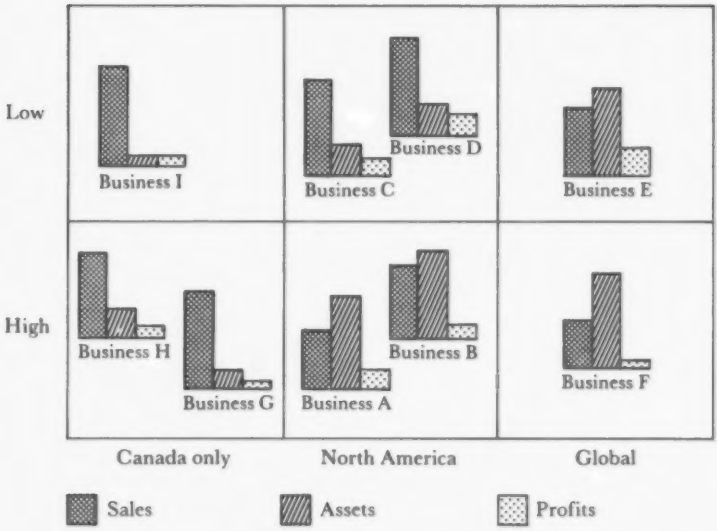
Circle size proportional to sales in Canada

provides a means for describing the strategic position of individual businesses and, consequently, for identifying the nature of the strategic environments they face. In particular, one may attempt to define the current positions on the grid of the business and its competitors by showing each as a circle whose area is proportional to its sales volume (as shown in Figure 3). Combined with the management team's predictions about the likely position of the competition five years hence, this can become the basis of dialogue between the management team and the subsidiary's corporate office about the future of the business. It will help to highlight potential problems about the viability of the business as global competition develops in its industry.

Second, the grid can be used to display the portfolio of the subsidiary's businesses (as indicated in Figure 4). Each business can be shown as a cluster of bars, one each for sales, assets, and profits. This will provide a summary of the overall strategic position of the portfolio. It can then serve as the basis for corporate strategic

Figure 4

The Corporate Profile of a Subsidiary



planning by the subsidiary. More importantly, it can be used for communication between the subsidiary's chief executive officer and the parent managers to whom he reports about strategic options for the subsidiaries.

Most remaining plants and satellite businesses will remain viable after the Free Trade Agreement is established.

Most Canadian branch plants were developed to take advantage of the opportunities created by Canada's National Policy of 1919. This policy was designed to foster the establishment, in a primarily agrarian economy, of secondary manufacturing developed through exports of natural resources. It created tariff barriers to protect local manufacturing from import competition. U.S. firms responded to the threatened loss of export markets by setting up branch plants to produce goods for sale in Canada.

Over the years, as Canadian exports of raw materials increased and the economy grew, these plants prospered. Their capacity was expanded to include new product lines developed by the parent. They came to resemble plants in the United States with one significant exception: scale. Because the Canadian market was relatively small, the production capacity needed to serve it was much smaller than that of similar U.S. plants. Instead of creating large plants dedicated to exploiting economies of scale, the Canadian subsidiaries created plants that produced a wide range of end products — miniature replicas of U.S. plants without the efficiencies that go with size. Economies of scale were sacrificed for the benefits of scope.[8] As Canada lowered tariff barriers to meet its obligations under the General Agreement on Tariffs and Trade, many of these plants became unviable when they were unable to meet competition from imports.

Most of these inefficient branch plants have already been closed because they are not competitive. Sunbeam shut down its small appliances plant in Whitby because it could no longer compete profitably with imports. Goodyear closed its old-fashioned, multi-storeyed tire plant in Toronto when the company realized that it could not match the quality and costs of modern, single-storey tire plants. The Goodyear plant was designed to manufacture bias ply tires and a large range of rubber products for industry. Bias ply tires have been replaced by radials, which can only be made in single-storey plants because they require heavier equipment that is prone to vibration. Production costs of the industrial rubber products were high because of short production runs and obsolete equipment.

The modern-day survivors of those U.S. branch plants that have not been rationalized are high-cost producers. They continue to produce a wide range of products that can still be sold in Canada

[8]For a description of these concepts, see Filip Caeldries, Krist'l Krols, and Rudy Moenaert, "Economies of Scope: An Analysis of Organizational and Competitive Issues" (Paper presented at the European Institute for Advanced Management Studies, Brussels, June 3-4, 1985). Managerial implications are also treated at length in Joel D. Goldhar and Mariann Jallnek, "Plan for Economies of Scope," *Harvard Business Review* 61 (November-December 1983): 141-48.

under the remains of tariff protection.[9] Furthermore, since they frequently use strategies to maximize short-term cash flow, their capital base has deteriorated. These businesses will not remain viable when the Agreement is implemented. Their production costs are higher than the larger-scale U.S. plants operated by their parents. For these businesses, the strategic options are clear:

- continue to operate as before, for as long as possible, until forced to shut down because of competition from imports, or
- rationalize; cut production back to a limited product line for sale in both Canada and part of the U.S. market in sufficient volume to achieve economies of scale, and replace the rest of the product line with imports from plants in the United States or elsewhere.

Rationalization will be a difficult strategy to execute. First, it requires negotiations with the parent for a mandate to serve a part of the U.S. market that is now being supplied by a U.S. plant.[10] Opposition from U.S. managers and labor affected by this move will have to be overcome. Second, rationalization will require considerable capital expenditure, which will be difficult to justify because it will not lead to an increased market for the corporation as a whole. Finally, many Canadian managers and the Canadian labor union will oppose replacing the Canadian production to be discontinued. These problems must be overcome, however, for the subsidiary to survive global pressures.

A strategy of rationalization will only be successful when combined with other strategic initiatives. For example, the Canadian subsidiary may be in a better position to exploit locally developed technological capabilities. Or, new products increasingly may be launched on a global basis, instead of by the traditional market-by-market roll-out

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[9]See Joseph R. D'Cruz and James D. Fleck, *Canada Can Compete: Strategic Management of the Canadian Industrial Portfolio* (Ottawa: Institute for Research on Public Policy, 1985).

[10]For a discussion of the difficulties in acquiring world mandates in multinationals, see Alan M. Rugman and Sheila Douglas, "The Strategic Management of Multinationals and World Product Mandating," *Canadian Public Policy* 12 (June 1986): 320–328.

that worked so well in the past. The cost of global launches creates further scale economy effects.

Thus, economies of scale are a key force behind the globalization of the knowledge industries. The huge fixed costs of product development, manufacturing, and marketing knowledge-based products must be spread over large volumes in order to keep unit costs at a competitive level. Therefore, access to a large market is imperative for success in these industries.

Many Canadian subsidiaries have already taken significant action in anticipation of these developments. General Electric Canada, for example, has completed a massive restructuring of its businesses in Canada. It has sold or shut down 30 percent of the businesses it operated in 1982. The remaining businesses have been streamlined and their operations modernized. The company reduced its Canadian workforce from 17,600 in 1982 to 11,500 in 1986. In the process, profits increased from $41 million to $56 million, with prospects for further improvement.

Two years ago, GE Canada's Chairman and Chief Executive Officer, William R.C. Blundell, initiated a thoroughgoing strategic audit of the company's entire operations. One motivation for the audit was the need to prepare a statement to the Canadian government on GE's position on free trade with the United States. The audit acquired further momentum when Blundell met with Jack Welsh, the parent company's head, to review GE's strategy in Canada. Welsh demanded that Blundell come up with a strategy to make GE Canada competitive, not just in Canada but on a global basis.

General Motors of Canada has embarked on a $450 million modernization of its Oshawa, Ontario, facilities. GM plans to make this its largest and most modern plant in North America. At the inauguration of this project, George Peapples, GM Canada's President, stressed his determination to turn the Oshawa plant into a showpiece of the corporation's technological prowess. The complex has been designed to serve the entire North American market, and will incorporate large-scale automation, just-in-time delivery, and computer control of every aspect of production management. Even more important, the Oshawa plant has been designed for maximum

flexibility. It will be capable of producing a wide range of medium and large cars, from the most fuel-efficient to the most luxurious. Peapples intends to insure that the plant will be capable of adjusting to changes in the demand for cars.

United Technologies is investing $90 million to build a new facility for its Pratt & Whitney Canada subsidiary in Nova Scotia, with another $75 million of investment assistance coming from the federal and provincial governments. This plant will contain Canada's largest Flexible Manufacturing System. It will produce components for small turbine engines for helicopters and light aircraft that Pratt & Whitney produces in its Quebec facility, including a new generation of engines being designed for the 1990s and beyond. Such strategic maneuvers will take advantage of the new opportunities that the Free Trade Agreement will create and position the subsidiary to cope with the new competitive environment of global competition that is emerging in these industries.

U.S. firms will find many advantages in continuing to do business in Canada.

Canada will remain an attractive place for investment by U.S. firms. Perhaps its most important advantage is relatively low wage rates for skilled manpower, compared with those in the United States. A leading U.S. electronics firm, for example, found that the fully loaded wage costs for production workers in Ontario were $19 per hour, compared with $44 per hour in upper New York State. What accounts for these differences?

First, a favorable exchange rate for the Canadian dollar helps.

Second, the cost of fringe benefits is lower in Canada, because many expensive benefits such as medical insurance and a large part of pensions are covered by government programs supported on the general tax base. In the United States, a larger portion of fringe costs is borne by the company directly.

Third, overhead costs are lower in Canada. In part, this is because overhead structures are smaller in Canada. And managerial and professional salaries are much lower for comparable skill levels.

A significant, though little-recognized, factor in keeping the costs

of skilled labor low in Canada is the relative insignificance of Canada's defense production industries. In the United States, in those industries where defense procurement is a major factor, the demand for skilled workers has increased labor costs. There is a natural preference for domestic sourcing of defense products; at the same time, a considerable part of defense procurement is conducted under cost-plus contracts. This combination of a lack of international competition with the absence of systemic incentives to economize on costs has encouraged defense industries in the United States to allow labor rates to rise.

Defense procurement rules also impose additional layers of overhead costs because of security procedures, reporting requirements, and the complex modes of interface between the company and the military bureaucracy. The impact of these management practices spills over into civilian production of U.S. defense contractors and into other firms that rely on common labor pools. As a consequence, U.S. rates for skilled labor in a number of high-technology industries in the United States are high.

In Canada, the defense procurement system is different. Major defense systems are not sourced domestically. Rather, the Canadian Forces tend to rely heavily on U.S. vendors. Furthermore, a larger part of Canadian defense contractors' business is in civilian or international markets. Therefore, Canadian wages and salaries for skilled workers in high-technology fields are significantly lower than corresponding U.S. levels.

These differences were an important factor in Bell Helicopter's decision to move production of civilian helicopters from Fort Worth, Texas, to a new plant outside Montreal. The cost structure of the Fort Worth plant is dominated by military production. In the face of vigorous international competition, the company found that its civilian product line could no longer be manufactured profitably at the Fort Worth plant. The new Montreal plant is dedicated to civilian production.

Canada has in place the educational infrastructure to support such moves. In 1985, Canadian universities produced more than 1,900 graduates with degrees in engineering and applied science, mathematics, and physical science. Technical institutes provide 11,000

graduates each year in areas related to electronics and telecommunications. Canadian standards of technical education are high, and U.S. firms find that recruits from Canadian universities are well trained.

What should the Canadian CEO do?

A number of U.S. subsidiaries appear to have made significant progress toward adjusting to global competition. We asked the chief executive officers of those subsidiaries that appear to have made the most progress what advice they would have for other executives in similar situations. In particular, we asked them to comment on what the CEO should do about the problems and opportunities created by the Free Trade Agreement. What follows is a composite of the advice of several respondents.

1. "Conduct a strategic audit of your businesses in Canada." The general managers of each business unit in Canada should be asked to address two strategic questions. First, what are the likely impacts of the Agreement on the business? Second, how will globalization affect the business?

These two questions should form the basis of a thoroughgoing strategic audit of the business. Use the Subsidiary Mission Grid to establish the present position of the business. Then, examine how viable the current strategy will be after the Agreement is in place and after the impact of globalization has made itself felt. It is likely that many managers will conclude that their current strategies will become untenable. Accordingly, they should examine alternative strategies that are more suited to the new conditions under which they will operate.

2. "Initiate negotiations with your parent office regarding new missions for your businesses." Prepare the ground for acceptance of the strategic audit conclusions by managers in the parent company. Get them to accept that the Canadian businesses are unlikely to remain profitable if they continue to be operated with the current strategies, and that some will become unviable. Remedying this situation will require a mission

change that will need home office authorization. This will involve negotiations with the general managers of U.S. business units affected by the changes. In some cases, it may be necessary to convince them of the advantages of sourcing some product requirements from a Canadian plant that is rationalized to serve both the Canadian market and part of the U.S. market. At the same time, for other products, it may be preferable to serve the Canadian market from a U.S. plant.

Strategic adjustments to Canadian businesses will require capital investment. It is important that home office managers understand the strategic rationale for each such capital appropriations request. By engaging in a dialogue with these managers about the changes taking place in your environment, you will improve your chances of a favorable reception to the capital appropriations request.

3. "Engage in a dialogue with Canadian governments about the changes that are taking place in your business." The period immediately following the implementation of the Agreement will be characterized by hypersensitivity in Canadian government circles about the behavior of U.S. multinationals. Politicians will be concerned that these firms may decide to shrink their operations in Canada by choosing to serve the Canadian market through exports from the United States. Major concerns will be the potential for a significant loss of jobs, reduction of research and development activity, and a reduction of exports. There may be a lack of recognition that these outcomes are an inevitable result of changes in global competition. Make sure that this is well understood.

If you have not already done so, make sure that the lines of communication between your firm and the federal and provincial governments are functioning efficiently. Ensure that politicians and bureaucrats understand the reasons for changes that you are planning to make in your businesses. Reassure them that your firm intends to remain a good corporate citizen in Canada. In particular, keep them informed about:

- changes in levels of employment;
- research and development activity;

- capital expenditure plans; and
- new business development.

Communications with these governments must continue to be free and open if the rationalization process is to proceed smoothly.

4. "Take steps to improve the international management skills of your Canadian managers." A number of studies have shown that Canadian managers lack competence in international management.[11] For example, the European Management Forum has identified the lack of an international orientation as a key weakness of Canadian management.[12] In particular, Canadian managers of multinational subsidiaries have tended to focus their attention on the protected Canadian market and, therefore, lack exposure to markets outside Canada. As a consequence, Canadian managers have not developed the skills needed to compete in global markets. This will be a severe handicap in subsidiaries exposed to U.S. and global competition.

In order to deal with this problem, initiate a four-step program as follows:

- Assess the international management skills of key members of the management team. Develop a list of high-potential managers who need to improve their international management skills.
- Send these managers to executive development courses that focus on developing international management skills. Alternatively, organize an in-house development program to provide this training.
- Once they have been trained, arrange for these managers to work outside Canada for a year or two in another part of the corporation. There is no substitute for hands-on experience in developing international management expertise.

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[11]For an extensive discussion of the shortcomings of Canadian management, see Donald J. Daly, "Canadian Management, Past Recruitment Practices and Future Training Needs," in Max von Zur-Muehler, ed., *Highlights and Background Studies* (Ottawa: Canadian Federation of Deans of Management and Administrative Studies, 1979).

[12]See Joseph R. D'Cruz and James D. Fleck, "The EMF Scorecard on Canada's Competitiveness: Mixed but Encouraging," *Business Quarterly* 51 (Summer 1986): 78–87.

• Arrange for managers from other parts of the corporation to come to Canada for a year or two to work in the Canadian businesses. This will expose a wide group of Canadian managers to foreign management practices. By providing opportunities for other subsidiaries to send their managers to Canada, it will be easier to place your managers in these subsidiaries.

5. "Restructure the corporate function in the Canadian subsidiary." Re-examine the functions of the Canadian corporate office. After the Free Trade Agreement is implemented, it may no longer be appropriate to maintain a large and expensive corporate office. Some corporate functions, such as money management, may be performed more effectively by staff in the home office. Similarly, corporate coordination functions between Canadian businesses and their U.S. counterparts may be candidates for elimination and replacement by direct links at the business manager level. The key corporate functions that should be retained are:

• liaison with the parent's corporate office;
• the maintenance of good relations with Canadian governments;
• the maintenance of the corporate presence in Canada.

The restructured Canadian corporate office should be small and inexpensive. It should consist of no more than five managers (including the chief executive officer) and a small support staff.

Canadian subsidiaries of U.S. multinationals face major strategic challenges as a consequence of the impact of global competition on their businesses in Canada. Unless they respond aggressively, their ability to remain competitive will be seriously diminished. The proposed free trade deal between the United States and Canada will provide these Canadian subsidiaries with a major opportunity for strategic adjustment and rationalization. Subsidiaries that succeed in taking advantage of these opportunities will find themselves well positioned to meet the competitive challenges of the 1990s and beyond.

Globalization: Today's Business Reality

Maureen Farrow

Introduction

Discussion at this conference has concentrated on the strategies business will employ in response to the new trading environment that the Canada-U.S. Free Trade Agreement will bring about. Implicit in this discussion is the recognition that Canada, as one of the most open economies in the world, is highly dependent on exports and that Canadian firms must take into account a phenomenon that is shaping today's business reality — namely, "globalization".

As the 1990s approach — indeed, as we stand on the threshold of the twenty-first century — the dramatic shifts in globalization that have occurred over the past decade and that continue to occur are forcing all countries to rethink their trading relationships and refocus their industrial and investment strategies. The world of today is very different from what it was just a decade ago. Ten years ago, 80 percent of the world's freighters and jumbo jets were operating in the North Atlantic. Today, that activity has shifted to the Pacific Ocean.

Canada, with close to 30 percent of its income and employment being generated directly by exports, is thus not alone in facing these challenges. In recognition of the forces of globalization and Canada's dependency on trade, the Canadian government is pursuing the

enhancement of Canada's access to foreign markets on two fronts: through the Canada-U.S. Free Trade Agreement and through the Uruguay Round of negotiations under the General Agreement on Tariffs and Trade (GATT).

This paper focuses on the globalization trends that are shaping the new trading configuration and international investment flows. This is followed by a brief outline of some of the more significant shifts that have occurred in world trade, and a discussion of the response of international investment to these shifts.

Globalization Trends

Several major long-term forces are shaping the world business climate:

- the growth of the newly industrialized countries (NICs);
- the shift in the location of manufacturing centers;
- the containment of inflation and the "commoditization" of both products and services;
- the international financial climate; and
- economic leadership.

One can argue that these trends are not exactly new, that they have been growing in importance since the early 1970s. But an appreciation of the extent of their impact on the world economy is of vital importance. The first two trends, for example — namely, the growth of the newly industrialized countries and the shift in the location of manufacturing centers — are of prime importance in influencing trade and investment flows.

The NICs — particularly the four so-called tigers of South Korea, Taiwan, Hong Kong, and Singapore — have moved aggressively from being manufacturers of textiles and low-value-added goods, with their competitiveness dependent on low-cost labor, to becoming increasingly highly competitive producers and exporters of value-added manufactured goods. Similarly, other Third World countries, such as India and Brazil, are now significant manufacturers and exporters of machine tools, aerospace equipment, and computer

Table 1

Net Manufacturing Output, Various Countries, 1986

	Output relative to the United States	Output as a percentage of total gross domestic product
United States	100.00	20.71%
Japan	50.47	30.08
West Germany	33.39	34.04
France	20.49	26.51
United Kingdom	16.62	23.65
Italy	13.52	27.30
Brazil	9.19	25.49
Canada	7.96	17.93
Spain	6.97	26.13
Mexico	4.92	21.06
Australia	4.79	19.07
India	4.05	16.69
South Korea	3.90	28.36
Netherlands	3.71	18.97
Sweden	3.40	22.82
Belgium	3.07	25.84
Austria	2.74	28.19
Taiwan	2.55	32.14
South Africa	2.49	24.38
Argentina	2.42	25.28
Hong Kong	0.95	22.76
Singapore	0.60	24.49

Source: United Nations, *Monthly Bulletin of Statistics*, various sources.

software, as well as basic commodities.

Although the relative importance of different centers of manufacturing has shifted over the past two decades, the United States is still the largest manufacturing center, followed by Japan and West Germany, as Table 1 indicates. What is surprising, though, is that Brazil's manufacturing output now exceeds Canada's and that of the four Asian tigers. Spain is performing close to Canada, and India's manufacturing output exceeds that of South Korea and many European countries.

The 1980s have brought a new phenomenon into Canada's business life, called "commoditization". By commoditization, I mean that the market today responds only to what it senses to be the

low-cost/high-quality product by world standards. This is a new definition of a commodity. Let me explain.

The current business cycle is the first in the postwar period where profit improvement has not been achieved primarily through price increases. Indeed, many Canadian businesses have experienced price depression and the resulting inability to pass on price increases. This environment of contained inflation has meant that companies that used to rely on price increases to obtain their profit margin must now turn to productivity improvement, cost control, and real "competitiveness", even during strong economic recoveries. In fact, from a business planning point of view, nearly all manufactured products, from intermediate goods (for example, petrochemicals) to the most high-technology products (minicomputers, electronic components, biotechnology, and medical instruments) must be regarded as experiencing commoditization, no matter how secure their current market niche.

The stock market crash of October 19, 1987, re-emphasized both the interdependence and fragility of the international financial climate. As we move into the 1990s, it is important to recognize and understand this tight interrelationship. Several long-range financial and monetary forces that will affect the worldwide business climate over the next decade are the debt crisis, inflation, interest rates, and exchange rates.

Throughout the Third World, the sharp rise in external debt relative to export prices over the past several years reflects the increasing burden placed on many of these countries by the decline in commodity prices. Latin America leads the way, followed by the large Asian debtor countries, and all now need to export an increasingly higher volume of commodities in order to keep current on their debt requirements. This problem is getting systematically worse, in spite of recent improvements in nonoil commodity prices, although total debt appears to be leveling off in Latin America primarily due to the reluctance of major banks to increase their lending and exposure there. But even if the debt were contained, increasingly austere government programs would still be needed to control inflation and to generate sufficient foreign exchange to make interest and principal payments. Over even a few years, this persistent austerity would

continue to raise political pressures within the debtor countries. Societies are willing to put up with high levels of economic restraint for only a limited time before searching for political alternatives. Ultimately, political pressures would lead to increased calls for abrogating the debt. The threat of such action almost inevitably will continue to strain world financial institutions well into the 1990s.

In contrast to the debt crisis, progress in dealing with inflation has been heartening. Most developing and developed countries now identify inflation as the problem that most threatens economic and political stability. For most of the developed world, inflation rates have been steadily declining for ten years. Only in the developing countries is inflation apparently a continuing problem.

An important related issue, from the perspective of world finance, has been the efforts of the finance ministers of the seven largest industrial countries to begin to reduce nominal interest rates on a worldwide basis. The results so far have been encouraging, although there is still concern about real interest rates. Falling nominal interest rates help debtor countries in Latin America and Asia to make their interest payments. In the industrialized countries, the lower nominal cost of capital helps to sustain the current recovery.

For the corporate bottom line, probably no fact adds more uncertainty to overall profitability than the widely fluctuating currency exchange rate we have witnessed over the past decade. The yen-dollar exchange rates illustrates this extremely well. Unfortunately, exchange-rate volatility will continue to be an issue into the next phase of the business cycle.

One final factor shaping the world business climate is that the viability of the United States' economic leadership is now being questioned. From a Canadian perspective, this obviously has major implications. As the United States has moved from being the world's largest creditor nation to being the largest debtor nation, a number of issues have emerged concerning the viability of its leadership role. No doubt, the United States will continue to play a significant role in determining world economic events. But, given the implications of globalization and the need to resolve current trade imbalances, the United States, Japan, and the European Community will have to coordinate their economic activities more closely in the 1990s.

The Strategic Implications of Commoditization

Commoditization and the increasingly globalized world economy have important strategic implications for business. Since product lifecycles for most products are shortening each year, value added will have to be achieved through niches. Business will also have to consider a global approach to the so-called Triad market — that is, the United States, Japan, and the European Community — and the need to produce low-cost/high-quality products by world standards.

Over the past decade or so, globalization forces have pushed multinational corporations into the Triad market. More and more during the 1980s, however, the Triad market has evolved beyond the original three to include South America, India, and China. If the characteristics of a triad-type economy are coming to mean a large market with stable growth, made up of countries that have a competitive, broad-based economy with compatible business practices that also offer potential regional and global linkages, then the world can be divided into the triad-type trading blocs of North America (made up of the United States and Canada); Europe (made up primarily of the United Kingdom, France, West Germany, and Italy, and the low-cost new manufacturing centers of Spain and Turkey); and Asia, with the configuration led by Japan, Korea, Taiwan, China, and India. A new triad-type economy is emerging in Latin America, made up of Brazil, Argentina, Chile, and Uruguay.

CEOs worldwide agree on two fundamental points. First, that the United States is their prime target market and, second, that Japan is or will be their number one international competitive threat.

New forces shaping the world economy mean that the strategic business planning concepts of the 1960s and 1970s are far less relevant in the 1980s and will be even less so in the 1990s. The competition is no longer other domestic manufacturers. Today, it frequently is foreign companies or foreign subsidiaries that may combine state-of-the-art technology with lower labor costs, lower capital costs, generous export financing programs, lower taxes, and a protected and secure home market.

These two factors, the declining importance of traditional commodities and the increased commoditization of all manufactured prod-

ucts and services, are critical for multinational corporations to understand in the development of their world strategies. Companies must also respond to the "value-added imperative". Any profitable product will attract competition. Developing a corporate culture to strive continually to identify new value-added improvements in products and business is therefore essential.

Shifts in World Trading Patterns

The globalization trends discussed in the previous section are reshaping world trade. The major newly industrializing countries, such as Asia's tigers and Brazil, are following Japan in capturing an increasing share of world exports, as shown in Figure 1. The NICs in particular, are relying less on commodity exports and are becoming increasingly effective in marketing value-added manufactured goods.

As world trading patterns have shifted, there have been winners and losers. In Asia, for example, since the early 1960s, South Korea has rapidly converted its economy from one highly dependent on agriculture and other commodities to one that has an increasingly impressive array of low-cost/high-quality manufactured exports. The Philippines, on the other hand, has had much less success in expanding its manufacturing sector during the same period, and agricultural and other commodities still account for nearly one-half of all its exports.

Brazil and Mexico also offer an example of contrasts. Brazil has modified its economy dramatically since the early 1960s. In 1962, it was primarily an agricultural, commodity-based economy, with 55 percent of its exports coming from coffee. Today, less than 5 percent of its exports are derived from coffee. In fact, soybeans, not coffee, are now Brazil's largest agricultural commodity export. What has changed over the past 25 years or so is that the overall size of the Brazilian economy and its manufacturing sector have increased dramatically. This value-added manufacturing includes autos, trucks, aircraft, machine tools, instruments, armaments, and other relatively high-technology goods that now compete effectively against North American and Western European products on the basis of both price and quality.

Figure 1

Shares of World Exports of the United States, Japan, and the Major NICs, 1953–85

Note: The major NICs include the Asian NICs and Brazil.

Source: International Monetary Fund, *International Financial Statistics*, various issues.

This contrasts vividly with Mexico, whose economy in the early 1960s was based principally on agriculture and oil but showing some signs of improving its manufacturing sector, partly as an export platform to the U.S. market. To a great degree, this movement collapsed during the 1970s. The dramatic rise in the price of oil made Mexico a one-commodity economy, with oil representing over 70 percent of its foreign exchange earnings; the rest came from tourism and a small level of manufacturing. These trends have produced a Mexican economy that is extremely fragile, and vulnerable to movements in international oil prices.

Because the rapidly growing economies of Asia are of moderate

size in terms of population and total market, they must trade in order to grow. (In the short term, large countries such as India and China can maintain high growth rates without trade because of their large indigenous markets and plentiful resources; but even they, over time, must develop their contacts with the outside world if they are to reach developed-country status.) Among the nonoil-exporting developing countries, those in Asia lead all others in exports, increasingly dominated by competitive manufactured goods. This trend should continue through the 1990s.

In summary, then, as globalization trends have taken hold, the centers of manufacturing have shifted to the NICs, and because of the NICs' need to grow by exporting, world trading patterns have changed significantly.

Canada and Market Access[1]

Another globalization trend in the postwar period has been the buildup of both regional free trade and common market groupings. It is worth noting that Canada is the only member of the Organisation for Economic Co-operation and Development, other than Japan, that is not in some form of free trade area or common market association. Furthermore, many less-developed countries are also in regional groupings. This reflects the simple assessment that, in today's highly integrated world, large markets really matter.

Canada is unusual in not having free access to a large market. Together with Australia and New Zealand, Canada is the only developed country whose industries do not have free access to a market of at least 100 million consumers. This must be viewed in the context of the following:

- Japan's local market is 120 million people;
- the U.S. market is 240 million people;

[1]The discussion in this section draws heavily on Richard G. Lipsey and Robert C. York, *Evaluating the Initiative: A Guided Tour through the Canada-U.S. Free Trade Agreement*, Policy Study no. 6 (Toronto: C.D. Howe Institute, 1988), especially their Introduction.

- the European Community and the European Free Trade Association have a combined market of 360 million;
- the Canadian market is 25 million people;
- the combined Australian-New Zealand market is 20 million people.

When Canada's exports were mainly primary products of which Canada was a major, and in some cases almost the only, supplier, the world beat a path to Canada's door. Access was not often a great issue. Today, markets are much more competitive. Suppliers of primary products have increased, technological revolutions have introduced many substitutes for these products, and Canada is now a major exporter of manufactured goods over which international competition is fierce.

Therefore, the globalization forces that have reshaped trading patterns make market access a key issue. It is for these reasons that the Canadian government's trade policy initiatives, both in the context of the GATT and with the United States, are of fundamental importance to the future of Canada's economy.

The International Investment Response

The forces of globalization have triggered a fundamental shift in global direct investment strategies. Since the late 1970s, the developing world has tended to be an important focus of multinational business attention. Low labor costs and improving education levels have made these countries more desirable than many of those in the developed world for international direct foreign investment.

Direct foreign investment during the 1980-84 period was far greater in Asia — other than Japan — than in any other region of the world. Much of this investment came from Japan, which continues to increase its investment levels in this region. In contrast, the United States slowed its level of investment in Asia and elsewhere in response to international banking problems in Latin America, to the recession, and then to the attractiveness of domestic investment in the post-recession period.

In Latin America, Japanese investors have been similarly aggres-

sive, while U.S. banks and investors have been pulling back somewhat. In fact, European inward investment in Latin America now exceeds that of the United States, with commitments in such industries as autos, heavy machinery, power generation, and communications. In developing countries in other parts of the world, a similar story is unfolding, although there is declining interest in Africa due to falling prices for raw materials.

In Europe, a different investment picture is emerging, reflecting two major trends. First, investment levels there are declining. This is principally because capital no longer follows the pattern of flowing freely from Europe to the United States to trigger recoveries, then back to Europe to stimulate the lagged recovery there. Increasingly, capital flows that are channeled to the United States during a recovery are removed, as its economy slows, into the Third World for better potential returns on investment.

Second, there is a relatively low level of European investment in Europe, and much of it is aimed at supporting current activities and not targeted at expansion. Both of these trends indicate the shifts in manufacturing centers that are taking place and the new patterns of trade that are emerging.

In North America, the United States has experienced continually rising levels of Japanese investment and steady capital inflows from European investors as the world's multinationals concentrate on the U.S. market as their main target. Similarly, Canada has invested strongly in the United States during the 1980s and has also been the recipient of strong Japanese and European capital flows.

A key conclusion from this brief review of direct investment flows is the increasing importance of Japan. By 1985, Japan had become the largest international banker in the world. Japanese investment has been strategically targeted to improve that country's industrial position in high-growth Asian markets and to develop longer-term positions in what are anticipated to be increasingly attractive markets in such areas as Latin America. In addition, Japan has maintained its relatively stable investment pattern in the United States. Japanese firms view their direct foreign investment as closely complementary to their overall manufacturing strategies. As such, this investment

serves as a hedge against the increasing risks of protectionism or resistance to Japanese market entry.

Conclusion

Given the impact globalization is having on trade and investment flows, the Canadian business community and Canadian policy-makers should be aware of the combination of ingredients that will help to ensure that an export-dependent country such as Canada finds its place in the new global order.

First, there must be an appreciation of the full dimensions of globalization. Then, having recognized these trends and, in particular, the need to concentrate on sustainable production of niche products, attention must turn to the trade and investment environment.

Second, Canada must develop into a sophisticated trader, forging new trading relationships around the world. This means completing the Free Trade Agreement with the United States and actively participating in the GATT. It also means new initiatives must be taken in Asia.

Third, in conjunction with these initiatives, Canada must foster a positive investment climate in order to continue to be an attractive host country for foreign direct investment.

The combination of these ingredients is important to ensure Canada's economic health and growth as the twenty-first century approaches. Managers need to think more about the forces of change and competitiveness that are shaping the world economy. In 1779, Benjamin Franklin said, "No Nation was ever ruined by trade." Consider how Canada would survive without trade, however, when we are dependent on exports for 30 percent of our incomes and jobs.

Report on the SAGIT Sessions

Alan M. Rugman

The objective of the three concurrent Sector Advisory Groups on International Trade (SAGIT) workshops was to generate discussion on business responses to the opportunities and changes involved in the Canada-U.S. Free Trade Agreement. For convenience, each of the three workshops consisted of a group of five SAGITs, roughly classified as resources, manufacturing, and services. Each of the SAGIT Chairs took about 10 minutes to present his or her views about the impact of the Agreement on the firms and industries represented by that SAGIT. Following these brief presentations, a question period allowed for interaction between conference delegates and SAGIT Chairs.

The conference reconvened in a plenary session chaired by Dr. Richard G. Lipsey, the C.D. Howe Institute's Senior Economic Advisor. The session was led by the three workshop coordinators, Alan M. Rugman of the University of Toronto, Maureen Farrow, and Edward A. Carmichael (both of the C.D. Howe Institute). They identified key common themes from their workshops and raised these themes for discussion by conference delegates. This process of interactive discussion generated a broad consensus about the key issues of concern to the private sector in adjusting to the new trading environment.

In the discussions in the SAGIT sessions, the delegates sought answers to the following questions. Now that the Agreement has been signed, what are the strategic options for Canadian corporations? Will the Agreement, together with the ongoing multilateral trade talks and the U.S. trade bill now before Congress, lead to fundamental changes in the environment of international business? What are the practical alternatives facing Canadian businesses as they seek to

adjust to this new trading environment?

An interesting conclusion to emerge from the SAGIT workshops was the almost universal feeling by conference delegates that the SAGIT process had worked. Strong support for the useful consultative role of the SAGITs was expressed in each workshop. Delegates felt that many of the potential adjustment problems facing individual companies had been avoided through the SAGIT process. In general, delegates recorded the feeling that their interests had been well represented by the SAGITs.

Another general conclusion was the view of most delegates that the Agreement had been successful in securing access to the U.S. market for Canadian businesses. Several of the SAGIT speakers and members of the audience spoke about U.S. countervail and antidumping actions against their companies. These people said that the new binational panel was a potentially useful improvement over the biased procedures they now experience. Several speakers also suggested that subsidies to U.S. companies should be examined and that the U.S. process of investigation against Canadian companies was expensive in legal fees and executive time.

Another theme examined was the extent to which the Agreement was one step toward further deregulation of the economy. Several speakers and delegates stated that the federal government should attempt further deregulation, especially to reduce interprovincial barriers to trade. Here, members of the food-processing industry identified severe problems for their sector in adjusting to free trade. Some delegates expressed disagreement with the papers on strategic management, which appeared to ignore the potentially severe problems of this industry. Due to the exemption of agricultural marketing boards from the Agreement, for example, the food processors expect to pay higher costs for inputs than will their U.S. rivals.

Given the resource-based nature of many of Canada's export industries, an issue of concern to many delegates was the level of the exchange rate. Several business speakers and questioners argued in favor of a Canadian dollar of under U.S.$0.80 in order to retain export competitiveness. They felt that if the exchange rate stayed at this favorable level, adjustment to free trade in resource-based sectors would be relatively easy. Above that level, problems could begin.

In the manufacturing workshop, one SAGIT Chair noted that Canadian industry has a favorable geographic location. Within 500 miles of Toronto, or two days by truck, lies 54 percent of the North American market. This should help to provide incentives for specialization and cost competitiveness, with scale economies being possible for Canadian-based firms.

In the services and culture workshop, the services chapter of the Agreement was viewed as a significant breakthrough in international trade negotiations. In general, delegates welcomed the principle of national treatment. It was remarked, however, that financial services now operate in a global industry subject to specific regulations. Until restrictions imposed in the United States under the *Glass-Steagall Act* come off, Canadian banks will not have access to the U.S. financial services market. Some delegates expressed disappointment that the negotiators were unable to include transportation and intellectual property in the Agreement, or to have made greater progress in removing barriers to trade in the area of government procurement. In short, delegates at this workshop felt that the Agreement is a start, but it leaves an unfinished agenda in the area of services.

List of SAGIT Chairs or Delegates

Workshop 1: Resources

SAGIT Name	*Chair or Delegate*
Agriculture, food, and beverages	*Gerald Doucet*, Partner, The Gloucester Organization
Energy products and services	*Robert L. Pierce*, President, NOVA, An Alberta Corporation
Fish, fish products	*Victor L. Young*, Chairman and Chief Executive Officer, Fishery Products International Limited
Forest products	*Raymond V. Smith*, President and Chief Executive Officer, MacMillan Bloedel Limited; *Adam H. Zimmerman*, Chairman, Noranda Forest Inc., attended for Mr. Smith
Minerals and metals	*William James*, Chairman, President and Chief Executive Officer, Falconbridge Limited

Workshop 2: Manufacturing

SAGIT Name	*Chair or Delegate*
Automotive and aerospace	*M. Jack Ripley*, Chairman and Chief Executive Officer, Allied-Signal Canada, Inc.
Chemicals and petrochemicals	*G. Firman Bentley*, Group Vice President, Polysar Limited

Fur and apparel	*Peter Nygard*, Chairman and President, Nygard International; Mr. Nygard did not attend
Industrial, marine, and rail	*Guy B. Champagne*, President and Chief Executive Officer, Exeltor Inc.
Textiles, footwear, leather	*Sandy Archibald*, Chairman, Britex Limited

Workshop 3: Services and Culture

SAGIT Name	*Chair or Delegate*
Arts and cultural Industries	*Marie-Josée Raymond*, President, Rose Films Inc.; *Ken Dryden*, lawyer, attended for Ms. Raymond
Communications, computers	*Alex Curran*, President, Telecommunications services and Computer Trade in Goods and Services Research Institute of Ontario (TRIO); *Grant G. Murray*, Vice-President, Corporate Relations, IBM Canada Ltd., attended for Mr. Curran
Consumer and household products	*Pierre Lortie*, Chairman and Chief Executive Officer, Provigo Inc.; *Jack Cooper*, Chairman, Jack Cooper Family Foundation, attended for Mr. Lortie
Financial services	*Jalynn H. Bennett*, Vice President, Corporate Development, The Manufacturers Life Insurance Company

General services	*Gail Cook*, Executive Vice-President, Bennecon Ltd., Management Consultants

List of Conference Speakers*

Michel Bélanger, Chairman and Chief Executive Officer, National Bank of Canada

Edward A. Carmichael, Vice-President and Director of Policy Research, C.D. Howe Institute

Max Clarkson, Faculty of Management, University of Toronto

John Crispo, Faculty of Management, University of Toronto

Joseph R. D'Cruz, Faculty of Management, University of Toronto

Maureen Farrow, President, C.D. Howe Institute

James D. Fleck, Faculty of Management, University of Toronto

S. Bruce Heister, President, Alcan Enterprises

Richard G. Lipsey, Senior Economic Advisor, C.D. Howe Institute

O. Victor Lonmo, President, Automotive Parts Manufacturers' Association of Canada

The Hon. Barbara McDougall, Minister of State for Privatization and Regulatory Affairs

Robert M. MacIntosh, President, The Canadian Bankers' Association

John Macnamara, Chairman and Chief Executive Officer, The Algoma Steel Corporation Ltd.

Judith Maxwell, Chairman, Economic Council of Canada

J. Edward Newall, Chairman, President and Chief Executive Officer, Du Pont Canada Inc.

Grant L. Reuber, Deputy Chairman, Bank of Montreal

Gordon Ritchie, Ambassador and Deputy Chief Negotiator for Canada

*With their affiliations at the time of the conference.

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Erik G. Rule, The Coopers & Lybrand Consulting Group

David Rutenberg, Professor of Business Policy, Queen's University

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